C 76

REPORT TO THE CONGRESS: PREFERRED RATE STUDY

Y3.P34/49

READEX FICHE best copy available

REPORT TO THE CONGRESS: PREFERRED RATE STUDY

NEWARK PUBLIC LIBRARY

JUL 2 1986

U. S. GOVT. PUBS
DEPOSITORY 376

U.S. POSTAL RATE COMMISSION

JUNE 18, 1986

For sale by the Superintendent of Documents, U.S. Government Printing Office
Washington, D.C. 20402

TABLE OF CONTENTS

	Page
SUMMARY	1
BACKGROUND AND STUDY METHODS	5
HISTORICAL SKETCH	9
RECOMMENDATIONS TO REDUCE REVENUE FORGONE: CALCULATING THE APPROPRIATION	11
A. Alternative Methods Of Calculating The Revenue Forgone Subsidy	11
B. Separate Subclass Option	18
RECOMMENDATIONS TO REDUCE REVENUE FORGONE: ELIGIBILITY	24
A. 'Commercial uses' reduction	24
i. Scope of the problem; basic approach	24
ii. Why our recommended "relatedness" standard is preferable to the alternatives	28
iii. Second Class	34
iv. Third Class	38
v. Fourth Class	48
B. Redefining Categories of Mailers	51
THE WITHIN-COUNTY SECOND-CLASS RATE SUBSIDY	59
ATTACHMENT I	

APPENDICES

A. A Policy History of Selected Preferred Mail Categories

B. The Unrelated Business Income Tax as a Model for New Eligibility Criteria

C. Uses of Preferred Rate Mail

D. Nonprofit Third-Class Study

E. Second-Class Study

F. Library Rate Study

G. Part One - Eligibility Administration: Methods and Problems
Part Two - Postal Service Statement

H. Are Preferred Rates Economically Inefficient?

I. Listing of Participants

SUMMARY

This Report contains the Postal Rate Commission's major findings and recommendations in the three areas prescribed for investigation by the Consolidated Omnibus Budget Reconciliation Act of 1985:

1. Reducing the postal revenue forgone appropriation by changing eligibility for nonprofit mail which advertises goods or services;
2. Analyzing who uses and benefits from the special rates for second-class mail (newspapers and magazines) delivered in the county in which it is entered, and the arguments for and against, and effects of, limiting access to this subsidized rate; and
3. Exploring the pros and cons of various possible ways of recalculating the revenue forgone appropriation, independently of any changes in eligibility for preferred rates.

As its inclusion in the Reconciliation Act indicates, this study has as a unifying theme the revenue forgone appropriation. Currently $716 million, it represents the present mechanism by which historically favored types of mail, and mail users, are publicly subsidized. Unlike the "public service" appropriation of past years, it does not fund Postal Service operating deficits. Its role is to allow the eligible mailers lower postage rates than would otherwise be available to them, by making up the resulting revenue shortfall from the Treasury.

We begin, therefore, with the issue most closely tied to the appropriation itself: how should its amount be determined?

In our hearings, three methods were proposed as improvements on the current practice. We agree with the proponents of these alternatives that the present system results in overstating revenue forgone, and so inflates the amount Congress is asked to appropriate. We analyze the alternatives, and explain our preference for one which measures the revenue forgone on each piece by applying the same proportionate contribution to the institutional (roughly speaking, "overhead") costs of the Postal

Service that is made by regular-rate pieces. This would reduce the appropriation by some $265.5 million annually, in the absence of any other reforms.

Continuing, however, we recommend that the revenue forgone appropriation should be eliminated (except for the relatively small amount supporting free mail for the blind, and some free categories connected with voting). The effect of this proposal on rates charged to preferred-rate users would be greatly mitigated by Congress' amending the ratemaking statute, which we likewise recommend, so that when recommending rates the Commission would take into account the public benefit of organizations eligible to use these subclasses. Virtually all costs of the Postal Service could then be recovered from mail users rather than taxpayers, and revenue forgone could be substantially eliminated as a Federal government expenditure.

This change, of course, goes somewhat beyond mere recalculation of the appropriation. All the same, we recommend it for serious, favorable consideration by the Congress.

The next main part of the Report deals with restricting eligibility for advertising or commercialized uses of nonprofit-rate mail. We have found that 45 percent of nonprofit second-class volume contains more than a minimal advertising content. We see no reason for public subsidization of nonprofit publishers' advertising, which is in competition with commercial publishers' efforts. Therefore, we recommend that the subsidy be continued for the editorial portion of the nonprofit publication only and that the advertising portion pay the regular rate.

We found that in nonprofit third-class mail -- much the biggest category in terms of usage and public subsidy -- about 28 percent of the mail contains advertising of some kind.

We developed a general principle for judging whether advertising mail should continue to receive any subsidy: whether the activity or thing advertised is substantially related, otherwise than just by raising funds, to the purpose of the nonprofit organization. Thus, for instance, a Native American welfare organization selling handmade craft articles produced in

furtherance of its programs could advertise them at the preferred rate; a college promoting a vacation tour as a fundraising device would use the regular rate. The general principle is based on the theory of the Unrelated Business Income Tax, enacted in 1950 to deal with the same kind of fiscal and fair-competition problems we are facing in the postal area today. We go on to show how practical oeprating rules could be developed from it, so that postal employees need not try to apply broad abstractions to the everyday job of accepting and rating bulk mail. In two cases singled out for special mention by Congress -- the promotion of travel and insurance -- we find it most appropriate to require all such advertising to go at commercial postage rates. Products and services in general would be judged by whether they were actually made or rendered by the organization's members or beneficiary group. Our quantitative study shows that half of all third-class nonprofit advertising would be eliminated by adopting these recommendations. This is 14 percent of current volume.

Fourth-class library rate mail comprises books, recordings, and similar matter sent by libraries, schools and other qualifying institutions among themselves, or by publishers to qualified institutional recipients. Our survey indicates that a vary large proportion -- some 44 percent of the pieces, and about 60 percent of the weight -- of library rate mail is sent by publishers. The principles adopted in the Report for evaluating subsidy in terms of relations to the nonprofit's purposes lead us to recommend that this eligibility, added to the law in 1976, be terminated. It has at best an indirect -- and purely monetary -- connection with the accomplishment of educational or other subsidizable ends.

The final portion of our Report deals with the current state of within-county second-class mail. Defined by geography rather than nonprofit organization, this rate preference has already been somewhat restricted by the Reconciliation Act. Here, Congress asked us to survey the situation rather than make recommendations of our own for changing it. We found, in general, that while legislators have consistently referred to the

in-county subsidy as one for rural publishers, many of the witnesses at our field hearings seemed to equate it with local news coverage rather than strictly rural publications. Our survey also indicates that the description "rural" is too limited for today's in-county users: the bulk of current in-county mail pieces are entered at central city post offices of large (population over a million) metropolitan areas.

In addition, a considerable portion of the second-class in-county subsidy goes to mail that is already preference-eligible: nonprofit publications contribute 34 percent of the in-county mail volume. In fact, over half of all nonprofit publications use the in-county rate to some extent.

Restricting eligibility for the in-county subsidy to publications with more than half of their total paid circulation in the county of publication eliminates only 12 percent of previously-eligible volume and reduces the in-county subsidy by about $9 million. If the in-county distribution test is coupled with a further restriction of eligibility to not more than 20,000 copies per issue, another 18 percent of in-county volume is eliminated and an additional $14 million is saved.

In preparing this Report, the Commission held public hearings in Washington and seven other cities, conducted quantitative studies of second- and third-class nonprofit mail usage and of the sender/addressee pattern of library rate mail, and commissioned a study of the history of preferred-rate categories. Throughout, we enjoyed the helpful cooperation of the United States Postal Service, mail user groups, participants in our hearings and our quantitative studies, and other governmental agencies. Much that is of value in this study could never have been accomplished without their help.

BACKGROUND AND STUDY METHODS

The Consolidated Omnibus Budget Reconciliation Act of 1985 directed the Postal Rate Commission to conduct a study of several matters affecting the revenue forgone appropriations for preferred categories of mail. As directed, the Commission submits this report to the Committee on Post Office and Civil Service of the House of Representatives and the Committee on Governmental Affairs of the Senate.

The subsidies which are being reviewed by Congress are for mail described in § 3626(a) of Title 39, U.S. Code. That section provides that certain mail that was eligible for preferred rates prior to the Postal Reorganization Act should not be subject to rates which exceed its direct and indirect attributable postal costs. Section 2401(c) authorizes appropriations to make up the revenues not received by the Postal Service because of the enactment of § 3626 -- the revenue forgone. Generally, revenue forgone appropriations apply to second class mail sent by qualifying nonprofit organizations or circulated in the county of entry, third class mail sent by qualifying nonprofit organizations, and specified types of library mail. Figure 1 depicts the volume of subsidized mail, by category, sent each year since 1972.

The Commission has been instructed to submit analysis on three separate topics.

> ... to develop recommendations for legislation which would reduce the amount of revenue forgone appropriations by changing the eligibility requirements of certain categories of subsidized mail which "advertises or promotes the sale of, recommends the purchase of, or announces the availability of any article, product, service, insurance, or travel arrangements;"

READEX FICHE best copy available

VOLUME OF PREFERRED RATE CATEGORIES

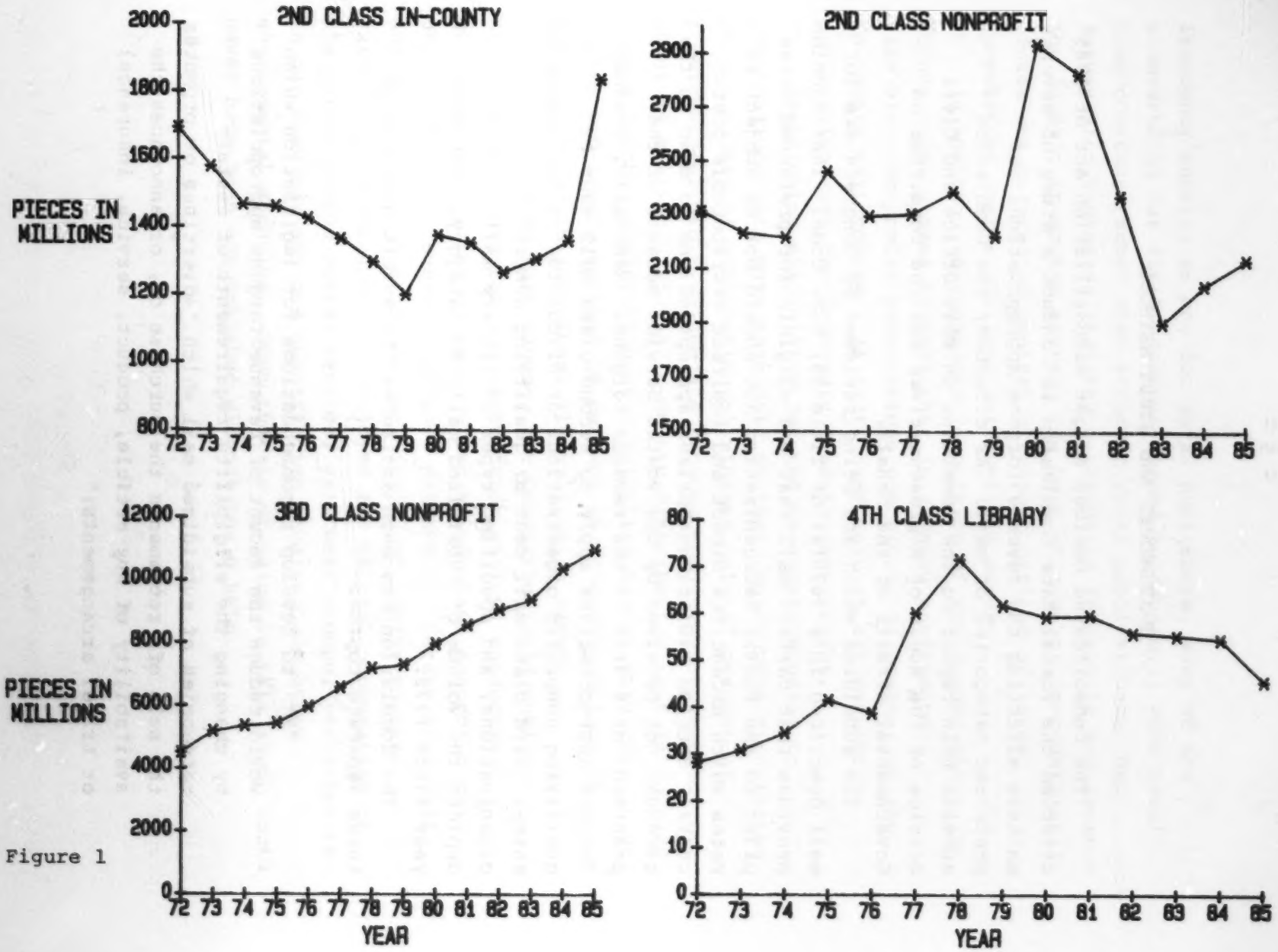


Figure 1

°°° to identify who uses or benefits from second class "within-county" rates and to examine arguments for and against restricting eligibility for those rates;

°°° to develop and discuss one or more alternatives to the current method used to compute revenue forgone.

Prior to final enactment of this legislation, the Chairmen of the reviewing bodies in Congress requested that the Commission begin its study immediately, so that it could be completed in time for consideration during the FY 1987 budget cycle. For that reason we publish our study at this time, although we may have to provide some minor data updates to reflect final tabulations. Such changes will not affect our analysis or conclusions.

Our study has involved developing both quantitative and qualitative information about mail currently eligible for preferred rates. The quantitative effort involved collecting information about what types of mailers use each of the categories of preferred rate mail, and what types of mail pieces are sent. In each of the data collection efforts, we were assisted by the Postal Service, and we would not have been able to conduct these studies without its cooperation.

The Commission's largest study effort was for third class nonprofit. Since we wanted to determine the amount and kind of advertising contained in this mail, the contents of actual mail pieces had to be examined. Postal Service data was used to draw a probability sample of 2,500 of the total 300,000 third-class nonprofit permit holders. These mailers were asked to furnish sample pieces and volume data from all mailings sent over the previous twelve-month period.[1] The responses were coded by type of advertising content and projections were made to estimate proportions of the annual volume of mail. A complete description of this study and results is contained in Appendix D.

---

[1] The twelve-month period was necessary to account for known seasonality characteristics of this mail.

For study purposes, second class nonprofit and in-county mail were combined since similar data were used for both. A sample of 1,500 of the 9,000 nonprofit second-class permit holders was selected and a sample of 1,500 of the 26,500 regular second-class permit holders was also selected. The Postal Service provided Statements of Mailing, Statements of Ownership data, and information on whether the publication was a magazine or newspaper. The data was keypunched and tabulated. A complete description of this study and tabulation of the results are contained in Appendix E.

For library rate, the Postal Service provided sender and recipient data from a random sample of this mail. Data on almost 2400 pieces was coded and tabulated. The Service has not yet developed statistical weighting factors however, so the results presented here may have to be adjusted shortly. A complete description of this study and tabulation of the results to date is contained in Appendix F.

Qualitative information about the uses and benefits of preferred rate mail was obtained from mailers themselves. As soon as the Commission was given the task of studying preferred rate mail it determined to hold field hearings and elicit comments from mailers and other interested persons. Public hearings were scheduled for Washington, D.C., and the five largest regional centers of preferred rate mail use: New York in the east, Los Angeles in the west, Chicago in the mid-west, Atlanta in the southeast, and Dallas in the southwest. Information about these hearings was widely disseminated to nonprofit groups and associations, and additional hearings in Denver and Minneapolis were held at the request of mailers. Additionally, written comments were solicited, and our study record was held open for three months to receive both the views of those who could not testify in person, and additional remarks by those who appeared, but wished to supplement the record.

Appendix I lists those who testified at public hearings. Additionally, over 450 written comments were received by the Commission concerning the study. Appendix C describes the contents of the preferred rate mail stream.

HISTORICAL SKETCH

Postal rates have reflected public policy from the earliest days of the republic. Initially, rate preferences were designed to foster the widespread dissemination of public information, and a strong local press, through low rates for periodical publications. There was even a period starting in the middle of the 19th century, when publications sent locally, or in the county of publication, were carried free. For some copies, free carriage lasted until 1951.

In 1879, the forerunner of the current classification structure was enacted by Congress, and different rates were developed for publications, bulk printed matter, and message mail. The rate distinctions between these classes can be directly related to the Congressional conclusion that the nation benefitted more from certain mail, particularly newspapers and periodicals, than from bulk printed matter. It was generally accepted that postal delivery of all publications was subsidized at that time.

In 1917, Congress established rate differences between publications sent by qualifying nonprofit organizations and other publications. It exempted the nonprofits' publications from an increase in the rate for advertising matter within the publication. The distinction between the rates for publications of qualifying nonprofit organizations, and other publications, has continued up to the present. There was widespread recognition that the rates for nonprofit organizations' mail, and in fact the rates for all second-class mail, did not cover its costs, see Appendix A, p. 37 et seq. However, it can be assumed that Congress intentionally priced second class below costs in consideration of the perceived benefit to the nation of distribution of a broad spectrum of ideas through inexpensive postage for newspapers and periodicals.

Preferred rate status was extended to bulk printed matter mailed by qualifying nonprofit organizations in 1951. As with

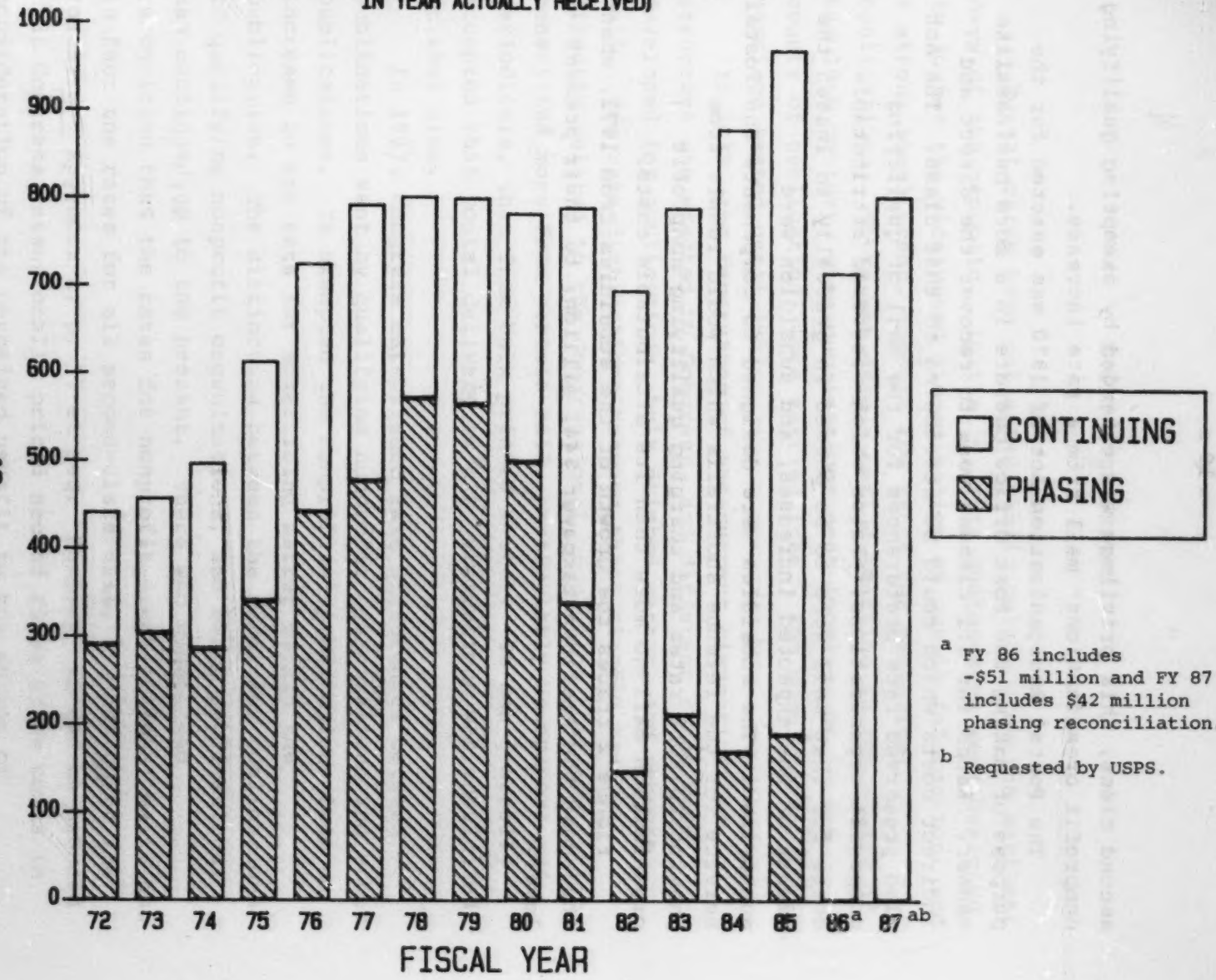
second class, this privilege was extended by exempting qualifying nonprofit organizations' mail from a rate increase.

The Postal Reorganization Act of 1970 was enacted for the purpose of making the Post Office operate in a more businesslike manner. Rates for all classes were to recover the direct and indirect costs which could be attributed to that class. The Act also preserved rate preferences for the mail of qualifying nonprofit organizations. Rates which recovered attributable costs for that mail were to be phased in gradually to lessen the impact of the expected increases, and subsidies were authorized. The subsidies were designed to compensate the Postal Service for the revenue shortfalls which would result from phasing in full rates and charging qualifying nonprofit organization mail no more than its attributable costs.

Figure 2 traces the growth of the subsidies from 1972, when they cost the American taxpayer $441 million, to their present level.

APPROPRIATIONS FOR PREFERRED RATE MAIL

(INCLUDES RECONCILIATION ADJUSTMENTS FOR PRIOR YEARS IN YEAR ACTUALLY RECEIVED)



[a] FY 86 includes -$51 million and FY 87 includes $42 million phasing reconciliation.

[b] Requested by USPS.

Figure 2

RECOMMENDATIONS TO REDUCE REVENUE FORGONE: CALCULATING THE APPROPRIATION

A. Alternative Methods Of Calculating The Revenue Forgone Subsidy

One of our major tasks under the reconciliation legislation is to explore alternative methods of calculating the revenue forgone subsidy and evaluate their respective advantages and disadvantages. While many methods of calculation are conceivable, there are three primary alternatives to the current method that were given serious consideration in the course of our hearings. One of these appears to us to be superior to the others, and superior to the current method as well.

The revenue forgone appropriation is an appropriation authorized under 39 U.S.C. § 2401(c) to compensate the Postal Service for excluding from the rates charged for the preferred mail identified in 39 U.S.C. § 3626 any contribution to the Postal Service's "overhead" or institutional costs.[1] Under § 2401(c), the Postal Service requests an annual appropriation in an amount that it determines "to be equal to the differences between the revenues the Postal Service would have received if sections . . . 3626 . . . had not been enacted and the estimated revenues to be received on mail carried under such sections and Acts."[2]

---

[1] Since the end of phasing, preferred rates are targeted to recover attributable costs. Previously, revenue forgone subsidies also included an amount to allow for phasing preferential rates up to attributable cost levels, but phase-in has ended.

[2] It should be noted that both the Kappel Commission study that furnished the analytical underpinning of postal reorganization, and the Commission on Postal Service, that reviewed postal reorganization in 1977 on behalf of Congress, recommended against the rate preferences now embodied in § 3626. See "Towards Postal Excellence," The Report of the President's Commission on Postal Reorganization 127 (1968), Annex II, pp. 6-13; Report of the Commission on Postal Service, April 1977, Vol. 1, pp. 67-68. Emphasizing objections to the Treasury subsidy, the latter report, at the pages cited, recommended a complete phase out of the preference over ten years.

The Current Method of Computing Revenue Forgone. To compute the revenue that it forgoes by charging each type of preferred mail only the costs specifically attributable to that type of mail, the Postal Service currently uses as a basis the rates charged for the regular rate category that corresponds to each type of preferred mail. It calculates the difference between the unit revenue actually received, and the unit revenue which would have been received if each piece of preferred rate mail had paid the existing regular rate. It then multiplies this difference by the forecast volume of the preferred mail to develop its budget submission. For 1987, its request was for over $743.5 million, distributed by categories as shown in Figure 3.

Alternative Methods. The purpose of the revenue forgone appropriation, as it is expressed in § 2401(c), is to make the Postal Service financially whole for keeping preferred rates at the level of attributable costs. The method used by the Postal Service to calculate the amount of revenue forgone does not adequately reflect the manner in which rates are determined by the Postal Rate Commission and the Governors. The principal criterion used to determine the revenue burden for each class is the percentage "markup" over attributable costs, that is, the percentage by which the revenue from rates for a mail class will exceed its attributable costs, and thereby contribute to the overhead costs of the system. The size of the markup for each class reflects application of the policies set out in § 3622(b).

A more representative measure of revenue actually forgone is the "equal markup" method. See Comments of Dr. John Haldi on Behalf of the Alliance of Nonprofit Mailers, Washington, D.C., March 12, 1986, at 3-4, 6-7, hereafter "Haldi." Each category of preferred rate mail exhibits different characteristics, and different unit attributable costs, than its corresponding regular-rate subclass. Therefore an unbiased way to calculate the contribution to overhead which is forgone by operation of § 3626(a) is to

FY 1987 REVENUE FORGONE APPROPRIATION REQUEST
BY CATEGORY OF MAIL
($ MILLIONS)

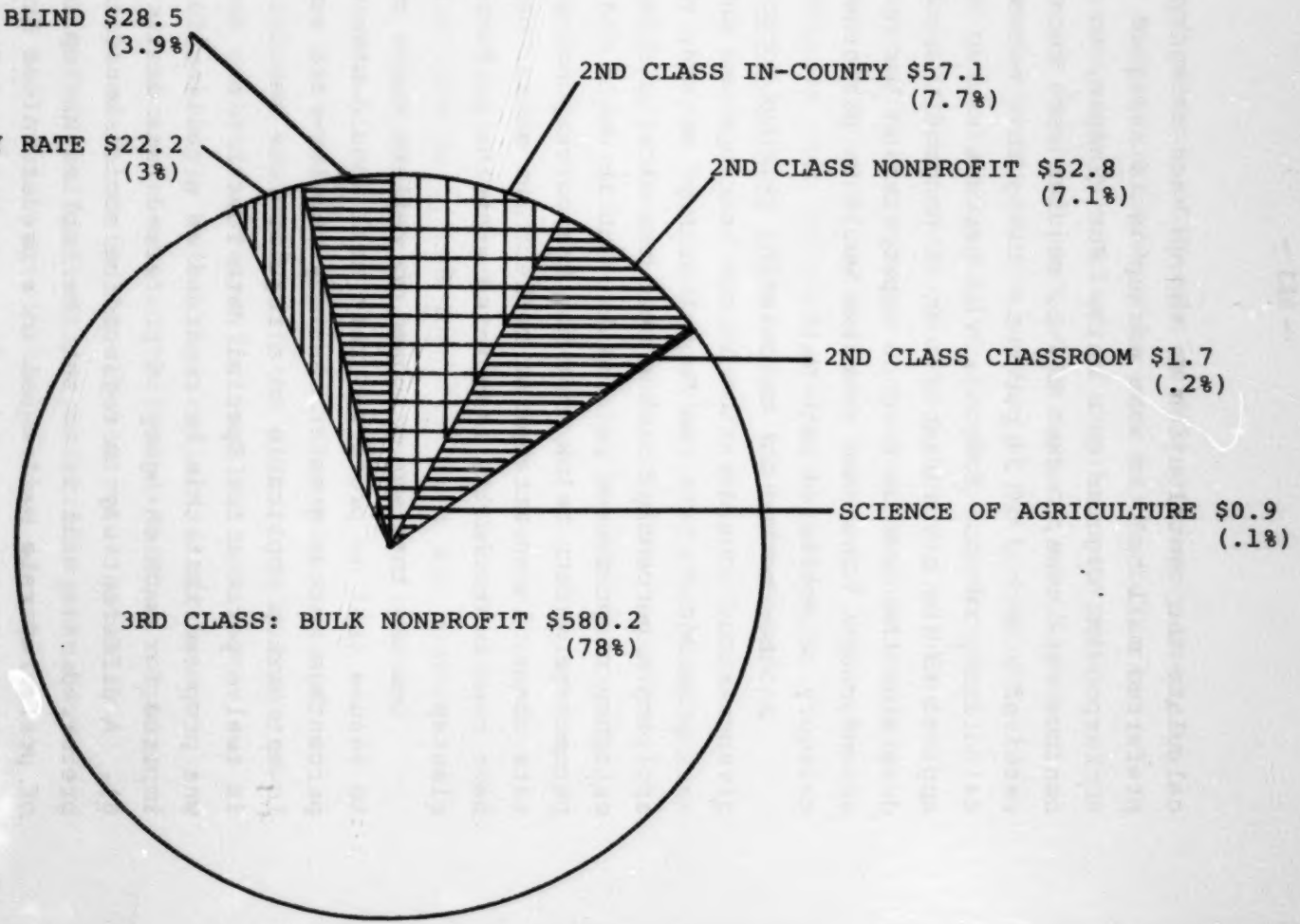


Figure 3

calculate the contribution as though each category of preferred mail had the same markup as is assigned to corresponding regular rate mail. For example, in the last omnibus rate case, Docket R84-1, regular rate second class received a markup of 24 percent. Using this method of calculating revenue forgone, a 24 percent markup would be applied to the attributable cost of nonprofit second class to determine the revenue forgone appropriation for nonprofit second class. The same exercise would be performed for each category of preferred rate mail.

Another method for calculating revenue forgone that was given serious consideration in our hearings was the "reduced markup method." Like the "equal markup" method, this involves applying a percentage markup over the attributable costs of a category of preferred rate mail. But it would reduce the percentage markup below that for the corresponding regular-rate class, in an attempt to reflect the social benefits that have been historically associated with the preferred classes.

One way that was proposed to reflect these benefits is to assume that no preferred rate mail should have an implied percentage markup greater than any regular-rate subclass. The lowest markup applicable to a regular-rate subclass currently is twelve percent for Special Rate Fourth Class matter. It was proposed that this be regarded as a ceiling for the markup implied for each category of preferred rate mail. (Haldi, p. 8). A different way to reflect the social benefits of preferred rate mail is to set the implied markup for each type of preferred rate mail equal to a predetermined fraction, such as one-third, or one-half, of the markup used for the corresponding subclass of regular-rate mail. (Haldi, p. 8). Revenue forgone would be equal to the reduced markup multiplied by the attributable cost of each preferred rate category.

The remaining method for calculating revenue forgone that received serious consideration in our hearings was the

"discounted rate" method. Like the method currently used, it would base its measure of revenue forgone on the full rate paid by each corresponding subclass of regular-rate mail. But, similar to the "reduced markup" method, it would seek to reflect the social benefit of the preferred mail. It was proposed that this be done by implying a discount from the corresponding full regular rate of some judgmentally selected percentage, 25 percent, for example. Revenue forgone would be calculated as the difference between the discounted reference rate and attributable cost for each preferred subclass.

Commission Evaluation. The method that the Postal Service currently employs to calculate the amount of revenue forgone subsidy does not accurately reflect the revenues that would be generated by preferred rate mail if these subsidies did not exist. This is because the primary measure currently used to set, compare, and adjust rate levels is the percentage markup over attributable cost. The current revenue forgone method would produce the desired result if preferred rate mail, and regular rate mail, had identical cost and content characteristics. Because they do not, the current method gives skewed results.

Currently, the generally lower attributable costs of preferred mail are not averaged with the attributable costs of regular rate mail in setting rates for regular mail. So regular rate subclasses pay rates that reflect a markup over their (higher) attributable cost. The Postal Service computes revenue forgone by reference to the regular rates actually paid, which has the effect of treating preferred rate mail as though it too had the higher attributable costs of regular rate mail.

If the various types of preferred rate mail were separate subclasses, and if rates for these preferred subclasses were separately determined, they would be set by marking up attributable costs by no more than the percentage that the corresponding class of regular-rate mail is marked up. As we discuss below, the content and sender

characteristics of preferred mail actually would result in reduced markups were separate preferred rate subclasses established.

Because the physical and cost characteristics for preferred rate mail and the corresponding regular-rate mail are not the same, the rates implied, even by equal markups, are not the same. To assume, in computing revenue forgone, that preferred rates would be the same as their corresponding regular rates regardless of these differences yields an arbitrary and nonrepresentative estimate. For this reason the current method for computing revenue forgone should be changed.

We find that the "discounted rate" method shares the bias of the current computation method, and adds the arbitrary aspect that a single discount factor is called upon to substitute for judgment as to how much the reference rate should be discounted to reflect the social benefits of the various preferred subclasses under varying sets of circumstances. For this reason we conclude that it is an unsuitable alternative.

The "reduced markup" method, though it reflects actual ratesetting procedures better than the current method, would also, like the "discounted rate" method, establish an arbitrary figure rather than informed judgment as the way to determine how much the regular rates should be reduced to recognize the social benefit of the various categories of preferential mail. This would be true whether the lowest markup for any regular rate subclass were selected as a rate ceiling, or an arbitrary percentage reduction were made in the markup applied to the corresponding regular rate subclass. Both would break the link between rates and the specific characteristics of a category of mail that should influence its cost coverage as set out in the Act, such as its value of service. Maintaining this link is the basic purpose of ratemaking, once it is determined that attributable costs are covered. For this reason we conclude that this alternative,

also, is unsuitable.

Since the "equal markup" method discussed above is based upon the measure that is used to determine rate levels generally, and to compare institutional cost contributions of the various subclasses, it corrects the above-described bias of the current method. It has the added virtue of employing objectively developed measures, rather than an arbitrarily chosen implied markup or reference rate discount.

In addition to producing a more equitable measure of revenue forgone, the "equal markup" method is likely to insure a less drastic impact than other alternative methods on the existing rate structure, and on share of overhead borne by preferred rate mail relative to similar mail sent by mailers not eligible for preferred rate status.

The attributable costs of preferred rate mail generally are lower than those of their corresponding regular-rate class. Therefore, if the "equal markup" method were used, those lower costs would be marked up by the same percentage as the corresponding regular-rate class. This would result in a lower rate, and a lower estimate of revenue forgone than the method currently used. For FY 1987, using the "equal markup" method would have reduced the estimated revenue forgone from $743.5 million to $478.0 million, a reduction of more than one third. See Table I.

Table I

Comparison of Current and Preferred Methods
for Calculating Continuing Appropriations

FY 1987
($ millions)

	Current Method		Commission Preferred Equal Mark-up Method	
Second Class:				
In-County	$57.2		$19.2	
Nonprofit	52.8		41.0	
Classroom	1.7		0.7	
Regular Rate	0.9		0.4	
		112.5		61.2
Third Class:				
Bulk Nonprofit		580.2		396.1
Fourth Class:				
Library Rate		22.2		5.8
Free for the Blind, etc.		28.5		14.8
Total		$743.5		$478.0

Notes: (1) Reflects revised second class eligibility requirements. (2) Does not include reconciliaton adjustment of $59.0 million. (3) FY 1987 current method data provided by Postal Service.

Assuming the categories of mail identified in § 3626(a) continue to be charged rates equal to their respective attributable costs, the impact of replacing the current method of computing revenue forgone subsidies with the "equal markup" method would be to shift roughly $265 million of overhead burden from the United States Treasury to the classes of mail paying regular rates, without affecting the preferred rate mailers. This would add less than 1% to the rate burden on regular rate mailers. Figure 4 illustrates the reduction in revenue forgone appropriations which would result from employing the equal markup method instead of the current method for computing revenue forgone.

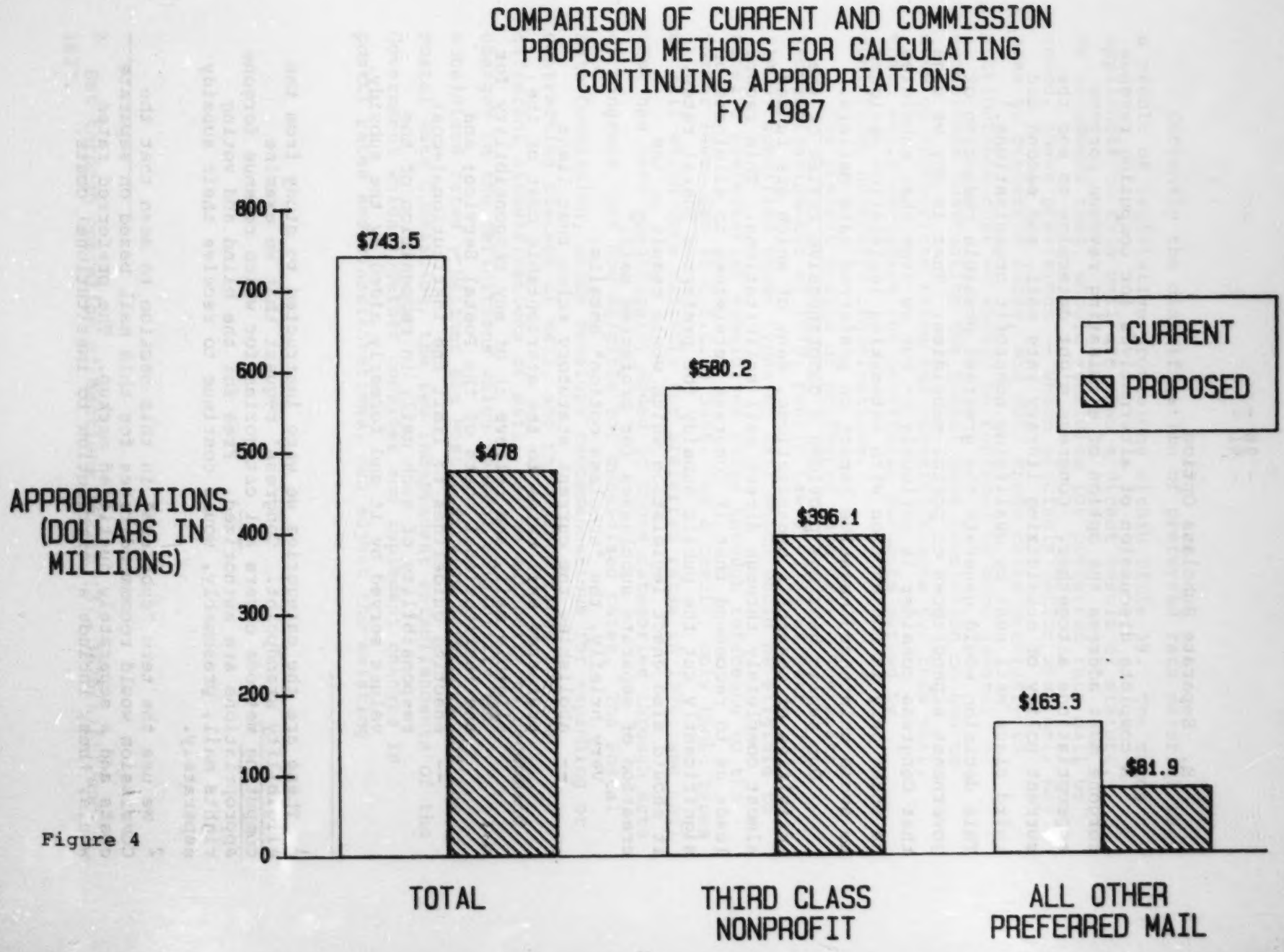

COMPARISON OF CURRENT AND COMMISSION
PROPOSED METHODS FOR CALCULATING
CONTINUING APPROPRIATIONS
FY 1987
APPROPRIATIONS
(DOLLARS IN
MILLIONS)
800
700
600
500
400
300
200
100
0
$743.5
$478
$580.2
$396.1
$163.3
$81.9
CURRENT
PROPOSED
TOTAL
THIRD CLASS
NONPROFIT
ALL OTHER
PREFERRED MAIL

Figure 4

B. Separate Subclass Option

A complete discussion of alternatives for computing revenue forgone must address the option of eliminating revenue forgone appropriations altogether. Congress might determine to end the current policy of subsidizing library rate mail, and second and third class mail sent by qualifying nonprofit organizations.[1] This decision would generate the greatest possible reduction of government expenditures on postal subsidies. That is why we urge that Congress consider it seriously -- but we urge that subsidies be ended only in conjunction with ratemaking legislation designed to avoid unintended negative impact on preferred rate mailers.

Our public hearings provided a comprehensive review of the activities of nonprofit organizations, many of which are funded almost completely through direct mail solicitations. This record leads us to recommend that if Congress determines to eliminate or significantly cut the public subsidy for preferred postal rates, it should also enact legislation which would result in the creation of separate subclasses for preferred mail.[2]

Very briefly, the "subclass option" entails:

-- abolishing the current statutory rules that limit preferred mail rates to the attributable cost of the eligible mail, and relieve it of any responsibility for the institutional costs of the Postal Service; and

-- enacting guidelines to limit the institutional-cost responsibility of such mail, in recognition of the values served by it and formerly aided by the subsidy.

---

[1] These are the categories we were instructed to study from the eligibility standpoint. Congress' request that we examine computing methods covers all categories for which revenue forgone appropriations are authorized. Free for the blind and voting rights mail, presumably, would continue to receive their subsidy separately.

[2] We use the term "subclass" in this section to mean that the Commission would recommend rates for this mail based on separate costs and a separately justified markup. The preferred rates would, thus, include a contribution to institutional costs.

Currently the classification of preferred rate material is a result of legislative provisions within Title 39. The rates applicable to this mail are also a direct result of statute.[3] We recommend that, should subsidies for preferred rate mail be ended, these provisions -- which precisely define what mail may pass at preferred rates, and hold those rates precisely to attributable cost -- should be replaced by more general guidelines instructing the Postal Rate Commission on how to develop appropriate rates and classifications for this mail, which would recognize the beneficial purposes served by qualifying nonprofit organizations.

The present status of preferred rate mail. The Postal Reorganization Act of 1970, Public Law 91-375, 84 Stat. 719 (1970) specified those types of mail which would be eligible to receive preferential subsidized rates through reference to the former law. See 39 U.S.C. § 3626. As a result, only those types of mail which were eligible for preferred rates in 1970, and mail that has been specifically added to those categories through acts of Congress, are now eligible for subsidized rates. The Postal Rate Commission, which develops recommendations for expanding or contracting classes of mail, and recommends rates for the different classifications of mail, has no authority to recommend changes in the definitions which control eligibility for subsidized rates. Neither the Postal Service Governors nor the Postal Rate Commission, the two independent establishments of the Government which together consider and implement changes in postal rates and classifications, can adjust the existing

---

[3] Set through operation of sections 3622(b)(3), 3626(a)(1) and 3627.

categories of preferred rate mail to eliminate or add groups of mailers or types of mail.[4]

The Postal Rate Commission is responsible for recommending classification and rate changes for all types of mail other than those defined by statute. Mail classification is the process of grouping mail "for the purpose of assigning it a specific rate or method of handling. Relevant factors include size, weight, content, ease of handling, and identity of both posting party and recipient." National Retired Teachers Association v. Postal Service, 430 F. Supp. 141, 146-7 (D.D.C. 1977), affirmed, 593 F.2d 1360 (D.C. Cir. 1979). The identity of the posting party as a nonprofit, or otherwise favored organization would, under this definition, support establishment of separate subclasses so that unique rates could be set for preferred mail matter. As "content" is also a factor for use in developing classifications, such subclasses would be defined further by the types of mail matter which advance the interests deemed worthy of support by Congress.

Any direction to the Postal Rate Commission to develop separate subclasses for charitable, educational, religious, or otherwise qualified organizations would be interpreted through reference to the language of the statute, and its legislative history, so that there would exist clear guidelines for the exercise of that authority.

Rates for the various subclasses of mail are set to recover attributable costs, and to make some contribution toward institutional overhead. The Commission allocates unattributable expenses between the subclasses to give effect to the policies set out in section 3622(b). Instructions to recognize and preserve the benefits to society fostered by revenue forgone

---

[4] As a recent example, in Order 593, issued December 11, 1984, the Commission was unable to consider whether computer-readable discs should be eligible for Library Rate. The list of types of mail eligible for library rate (books, films, etc.) was established by a statute [former section 4554(b),(c)] enacted before computer-readable discs were a widely used medium.

subsidies would certainly result in nonprofit subclasses providing low levels of contributions to institutional cost.[5]

The Postal Rate Commission has recognized that classifications must be developed which allow it to apply the factors set forth in § 3622(b) in developing rates. Thus insertion of additional instructions within 3622(b) would be adequate to guide the Commission in recommending both rates and classifications. Congress took this step in Pub. L. 94-421 (1976) by adding § 3622(b)(8), instructing the Commission to give more consideration to the values characteristically served by books and periodicals when setting rates.

The addition of a new factor requiring the Rate Commission to set rates which reflect the value of certain types of mailers and/or mail need not entail a radical change in the levels of preferred mail rates.[6]

This year, for the first time since reorganization, Congress determined not to appropriate the full amount of revenue forgone, and the Postal Service has acted to recoup the deficiency by charging preferred rate mailers rates above attributable

---

[5] As a result the institutional cost contribution of regular rate mailers would increase to cover the difference between the new contribution of preferred categories and the revenue forgone subsidy. Some observers refer to this consequence as a cross subsidy. We reject this view. In economic terms no cross subsidy takes place as long as rates cover marginal costs. While it is true that the new preferred category subclasses would have low institutional cost contributions, so do many regular rate categories; for example, although the average contribution in the last rate case was 152 percent, it was 124 for regular rate second class, 116 for parcel post, and 112 for special rate fourth class.

[6] When appropriations for rate subsidies fail, as they did in part in 1986, Postal Service may recover the lost income from subsidized mailers. Alliance of Nonprofit Mailers witness Haldi suggests that the rates for nonprofit organization mail would be lower if separate subclasses had been established.

costs.[7] Table II shows the extent current preferred rates include an implied markup above attributable cost rates and the amount by which revenue forgone would be offset if these rates remained in effect through FY 1987.

Table II

Preferred Rate Cost Coverages and Revenue Contribution Based on Rates Placed in Effect April 20, 1986

	Coverage	Offset to Revenue Forgone ($ millions)
Second Class:		
Within County	117%	13.5
Nonprofit	106%	10.6
Classroom	120%	.4
Third Class:		
Bulk Nonporofit	113%	123.2
Fourth Class:		
Library Rate	112%	4.9

Establishing separate, non-subsidized subclasses would also eliminate the disruptive rate instability which currently exists when Postal Service deems it necessary to adjust preferred rates to account for any shortfall in appropriations. See § 3627.

In order for the Commission to exercise this authority, 39 U.S.C. § 3626(a) would have to be repealed; however, mail currently eligible for preferred rate treatment under that section would continue to be eligible for any new preferred rate subclass absent a finding that the intent of Congress was that certain types of mailers or mail matter now eligible for

---

[7] The procedure used by the Postal Service to implement these rate changes is under review as National Newspaper Association et al. v. Postal Service, CADC Nos. 86-1161, 86-5160, argued May 13, 1986.

preferred rates should no longer be so favored. As noted below (pp. 34-50) we recommend some eligibility restrictions even if all subsidies cease; at least for competitive reasons, the need for restrictions turns on the existence of preferred rates -- not just on the availability of public subsidies.

Statutory language which would eliminate revenue forgone subsidies, while preserving favorable rate treatment for mail currently benefitting from those subsidies is set out as Attachment I to this report. This mechanism would allow the Postal Service and mailers to participate in determining appropriate rates for this mail.

In summary, we recommend that Congress consider favorably the option of creating subclasses for mail currently paying preferred rates, giving guidelines for limitation of these subclasses' institutional cost contribution, and thereby allowing complete discontinuance of the revenue forgone appropriation.

RECOMMENDATIONS TO REDUCE REVENUE FORGONE: ELIGIBILITY

A. 'Commercial uses' reduction

i. Scope of the problem; basic approach

The Commission was charged with making recommendations for reducing revenue forgone appropriations, by modifying eligibility requirements for preferred rate mail which "advertises or promotes the sale of, recommends the purchase of, or announces the availability of any article, product, service, insurance, or travel arrangements.

Our recommendations address the question: What portion of advertising in the nonprofit mailstream should be eliminated? To answer this question, we must first determine

-- what mail is potentially subject to exclusion; and

-- what is the best way of deciding what mail to exclude

Of course, any advertising restriction would affect only those pieces that contain advertising. As noted elsewhere in this Report, 72 percent of bulk nonprofit third class contains no advertising. This mail would continue to receive rate preferences. Our analysis of commercial uses of nonprofit third class focuses on the 28 percent of the mailstream that does contain advertising.

Similarly, nonprofit second-class publications having more than 10 percent advertising content are only 44.6 percent of the nonprofit second-class mailstream. (The 10 percent figure is significant because existing law allows nonprofit pieces with under 10 percent advertising to be treated as if they contained none.)

Thus 28 percent of third-class, and 44.6 percent of second class, nonprofit mail are subject to the analysis which follows.

As a general basis for reducing eligibility, we recommend the requirement of a definite relationship between the product or service advertised and the function or purpose of the organization entering the mailing. Currently, the only requirement for eligibility is that the organization as a whole fit into a particular category: educational, religious, scientific, and so on. It may use the preferred rate for

anything it chooses to mail in the particular class -- regardless of the commercial or advertising orientation of the mailpiece or its relationship to the mission of the organization. Our recommendation would make eligibility turn on these issues as well.

This "relatedness" theory is not a new one. Appendix B discusses the Unrelated Business Income Tax (UBIT), enacted to limit the Federal income tax exemption formerly available for all commercial and business income of nonprofit organizations. Before its enactment in 1950, any income, from any activity, that went to an exempt nonprofit entity was not taxed. Competitive and fiscal concerns -- similar to those that motivated the present study -- led Congress to require that business income be substantially related to the nonprofit's exempt purpose before it could escape taxation.

While we subsequently develop practical rules for application of our relatedness test to postal problems, a few examples may be given here.

If a rehabilitation clinic, as part of its rehabilitation program, has patients produce handicraft items, those products are substantially related to the clinic's function and a brochure advertising them would pass at the preferred rate. On the other hand, if a college advertises clocks inscribed with the college seal, for fundraising purposes, the sales activity does not have the requisite relationship with the college's educational mission. The advertisements would pay the regular third-class rate.

It is essential in adapting the UBIT test to recognize that production of funds which will then be applied to the charitable or educational activity does not suffice to create the needed substantial relationship. The tax code definition is clear: a business

> . . . the conduct of which is not substantially related (aside from the need of such organization for income or the use it makes of the profits derived) to the exercise or performance by such

> organization of its charitable, educational, or other purpose or function constituting the basis for its exemption under section 501 . . .

is an "unrelated" business, and its net income is taxable. 26 U.S.C. § 513(a). The same rule would apply to preferred rate eligibility. For that reason, the clocks described in the second example are not a related sales activity even though their sale raises money for the college.

Requiring this type of causal relationship between sales activity and the mission of the organization reflects a judgment that certain types of activities (educational, scientific, religious, etc.) are the proper objects of public subsidy. That an organization carries on such activities need not, and in our view should not, mean that all its other activities should be subsidized on the same terms.

We therefore recommend that Congress make substantial relation between the activity or thing advertised and the subsidizable purpose of the eligible organization the basis of entitlement of any advertising mailing to preferred rates.

In applying this general principle, we should not recommend rules that hamper practical administration. Postmaster General Casey urged us to consider the administrability of any recommendation we make; we agree. The Third Class Mail Association suggestion that the UBIT test of relatedness be applied directly to preferred rate eligibility, therefore, takes the right approach but does not go far enough. Just as the Internal Revenue Service has drawn up a body of rules and illustrative examples of relatedness to help apply the UBIT to specific cases, we are confident that practical rules can be developed for the Commission's relatedness test.

The key to practical, administrable rules is to require that mailers design their mailpieces containing advertising in such a way that the claimed relationship between advertised article and charitable mission appears clearly. In our rehabilitation clinic example, above, the advertisment should make it clear that the handicraft items were made by patients. Thus postal personnel will not have to speculate about the intent of the mailing or its

possible relationship to the nonprofit's primary purpose.

In addition, permits granted by the Postal Service for preferred rate mailing would include a description of the legitimate uses of the preferred rate -- i.e., those substantially related to the primary mission.

Independence of eligibility and budgetary questions. It is important to recognize that eligibility questions would persist even if revenue forgone subsidies were reduced through changing the method of calculation or eliminated through the "subclass" mechanism described above. The possibility of adopting one or the other of those changes does not lessen the need for a sound theory of eligibility restriction. This is so for two reasons, one budgetary and one economic.

If Congress decides to mandate recalculation of the revenue forgone subsidy, the obligations on the Treasury will still be substantial. If part of that obligation is unnecessary, when judged by a consistent theory of appropriate subsidization, then the current pressures on the federal budget make it particularly important that we eliminate it.[1]

Perhaps more important is the question of fair competition. In the first place, it would persist even if subsidies from the Treasury were totally eliminated by the "subclass" mechanism. While no more tax money would flow into the postal system to aid preferred-rate mailers, and those mailers would be contributing to institutional cost, their mail would still enjoy a rate advantage by comparison with commercial mailings of the same class. The extent of the fair-competition problems resulting from today's subsidization by the taxpayer would be less, but they would not disappear.

From the standpoint of competition, it is the differential in rates -- whatever makes it possible -- that causes the

---

[1] In Appendix B, at p. 24, it is noted that the revenue-forgone context -- unlike the internal revenue situation at the time of the Revenue Act of 1950 -- involves a measurable amount of federal expenditure and methods of reducing it which are likewise measurable.

problem. Hence it will still be important to restrict eligibility to those activities we wish to promote, even if we totally eliminate public subsidy as the chosen instrument of assistance. Identifying activities that are not sufficiently related to the eleemosynary purposes that are the object of rate preference, and may be in competition with for-profit firms, has a value quite independent of any reduction in revenue forgone subsidies it might also make possible. Complaints of competitive unfairness arise today because we permit qualifying organizations access to the preferred rates for virtually any mailing activity. That problem can be resolved only by making distinctions among their activities that reflect as closely as possible the real purpose of the rate preference.

ii. Why our recommended "relatedness" standard is preferable to the alternatives.

Our recommendation to use the "relatedness" standard is not the only available option, and below we review others which either seem immediately apparent, or were suggested by the participants in our investigation. We acknowledge the participants' efforts in support of our task through the development of these suggestions; their comments have been helpful in formulating our recommendations. We conclude, however, that on balance only the relatedness standard combines the characteristics of a firm overall policy, together with elements of economic and public-interest fairness, and also strives to eliminate undue preferences among charitable purposes.

The Third Class Mail Association proposal. The Third Class Mail Association (TCMA) suggested basing eligibility on the UBIT. Its proposal is discussed in some detail in the attached Appendix on the UBIT and the relatedness concept. Our discussion of it, at this point, identifies those areas where it coincides with our recommendations, and criticizes those where we believe it falls short of a workable alternative for the Postal Service.

At page 6 of its Comments, TCMA transposes almost the exact UBIT test on relatedness to postal terms. It proposes application of this test by mail clerks who would measure the

"goodness of fit" between the mail piece and the nonprofit's purpose. TCMA contends that UBIT relatedness test has a cogent rationale and is administratively workable. See Comments of TCMA at 11.

More specifically, TCMA identifies the commonality in purposes behind tax exemptions and preferred rates: to recognize the social costs avoided by the nonprofit organizations and to protect them in their mission to contribute charitably to society. To the extent that these purposes can be recognized in a cogent policy which forms the basis for determining who should receive favored status, we agree with TCMA that such a rationale is preferable to current standards, which simply identify or list the favored nonprofit organizations. (We discuss in greater detail, infra, why we do not recommend that this approach be extended.) Thus an important aspect of our recommendations -- like TCMA's -- is that they are designed to incorporate an overall policy for determining preferred status.

A third purpose of the tax laws (besides recognizing avoided costs and protecting beneficent purposes), which is codified in the UBIT, is to identify and eliminate from favored status those nonprofit activities which are "unrelated" to their charitable mission, and thereby eliminate "unfairness" to for-profit organizations who conduct these same activities but without the preferred status.

The UBIT seems to us -- as it does to TCMA -- to subserve all the above purposes. Where we depart from TCMA's recommendation is where it suggests that the UBIT relatedness test -- verbatim -- would be administratively workable in the Postal Service.

As noted above, TCMA suggests that postal operations can be modified fairly readily to permit mail clerks to measure the purpose of a mailpiece against the nonprofit organization's purpose. It also suggests IRS participation in the review process. Letter of Herb Gertz, Executive Vice Chairman, TCMA, to Chairman Janet D. Steiger, March 17, 1986, at 2. We conclude that these suggestions are not sufficiently expedient for postal

operations and could, in fact, prove more obstructive to the present mail flow. We would agree that the test is specific enough to serve as a basis for rules, but we think applying it directly would involve more time-consuming (and perhaps debatable) judgments than the postal workforce should be asked to undertake. Because each mailing is potentially a difficult decision, and a nonprofit may enter many separate mailings in the course of a year, the relative administrative burdens might well be greater than in the income tax context.

As indicated earlier, our suggestions would, instead, place the task of identifying qualifying mail on the mailer. TCMA's additional suggestion that mailers attempt to qualify their mail for preferred status prior to mail acceptance is more adaptable to postal operations. We have taken this aspect of its proposal one step further and recommend that mailers be required to mail only qualifying mail pieces at the preferred rate, in order to obtain and keep a nonprofit permit. Thus, we would establish a general principle of responsibility on the part of the mailer, before the mail piece reaches the acceptance point, to identify qualifying mail on the face of the mailing and to forbear sending, at the nonprofit rate, anything but qualifying pieces in order to receive authorization to use it.

The alternative of listing qualifying organizations or uses. An alternative to these suggestions would be to retain the current system of listing favored organizations and extend it by listing favored uses. This option has the advantage of simplicity of content, and perhaps is appealing because it essentially maintains the current format of a simple list. But these same characteristics cause significant theoretical difficulties. We believe that what this option offers in terms of simplicity and familiarity, it gives up in terms of practical administrative efficiency and a solid, cohesive policy base.

For instance, we have seen from the attached Appendix by Professor Kielbowicz that Congress amended the list of nonprofits "piecemeal," and it is easy to see how each round of new

legislation and/or hearings could tax the administrative resources of Congress and the mailers. See Appendix A at 5.

A related but perhaps more important issue, in this context, is what that practice has meant in terms of the underlying motivations for granting or withholding preferred status. As Professor Kielbowicz indicates, without a consistent rationale for making those decisions, preferred status often was the product of legislative grace:

> In some cases, an amendment late in the legislative process added a new group of mailers without prompting any discussion. Members of Congress added a few preferences to accommodate particular constitutents, some of whom intervened in the formal legislative process, while others pressed their case informally. In short, the list of preferred mailers grew in piecemeal fashion, and Congress never articulated a comprehensive policy that explained why some but not all nonprofit groups were entitled to reduced rates.

Appendix A at 5.

Consequently, besides the issue of fairness between for-profit and nonprofit groups, which we discussed above, the practice of a simple Congressionally-established list of organizations or uses raises questions of fairness among the nonprofit groups, themselves. Thus, we believe a significant advantage of our recommended relatedness standard is that it substitutes an underlying policy rationale for the current ad hoc policy making.

The proposed alternative of abolishing subsidies. The listing of uses or organizations can be characterized as one end of a spectrum of eligibility criteria which simply admits, to favored status, any of various Congressionally preferred charitable purposes. At the other end of the spectrum would be a proposal, like that of the Association of Business Publishers (ABP) and the Heartland Institute, who suggest an outright ban on the subsidies for preferred mail categories. (ABP proposes mail subsidies only for the blind and physically handicapped.)

ABP, for instance, argues that, as a matter of fiscal policy, postal subsidies should be eliminated. It discusses generally, priorities among governmental subsidies: "Certainly there should not be postal subsidies in addition to tax subsidies." Testimony of James Mulholland Jr., on behalf of the Association of Business Publishers at 6, March 12, 1986; Tr. 1/80. Further on in its testimony, it states: "A political answer is not a realistic or useful answer to the deficit problem and as compared to other needs, postal subsidies have got to be the lowest priority of all." Testimony of ABP at 8; Tr. 1/83.

Our difficulty with this recommendation is that we believe it is beyond the scope of the task which Congress has assigned to us, and also is a judgment beyond the Rate Commission's special expertise. Congress asked us to develop alternative eligibility criteria for mail which advertises goods or services. To the extent it has thus defined the limits of our task, we must adhere to those terms.

Of equal importance is the basic premise from which the ABP proposal proceeds: that the aboliton of subsidies is a matter of fiscal policy. We agree, and conclude that banning subsidies on basic economic and fiscal grounds is a judgment of national economic policy, rather than a matter for an administrative agency such as this Commission.

Proposed bans on particular activities. There are other proposals which lie between an outright admission to a list of preferred uses, on the one hand, and an outright ban on subsidies, on the other, but which are not as discriminating as our recommendations. These entail a ban on particular, broadly defined activities.

For instance, the U.S. Small Business Administration (SBA) suggests a ban on the subsidy of commercial mailings by nonprofits. Tr. 1/114. Another example is Magazine Publishers Association's (MPA) proposal to prohibit the mailing of advertising at third-class preferred rates. Tr.

1/55. MPA argues that this option, "would avoid the quagmire of defining unrelated business activities." Id.

A difficulty with the MPA approach is that while it eliminates determinations of unrelated business activities, it would immerse the Commission (or the Postal Service) in judgments of what constitutes advertising. Without addressing the specifics of this problem,[2] we believe this general approach may also unintentionally eliminate, from preferred status, announcements of activities which have the same beneficent purpose as the nonprofit organization. See Appendix B. Congress historically has sought to foster these purposes and MPA acknowledges the need to "protect the worthy purposes of many nonprofit activities." Tr. 1/55.

In order to meet that need, we believe that a standard more precise than an outright ban on certain activities is necessary. SBA appears to acknowledge this when it suggests the additional option of a limit on the commercial information in a particular mailing, or over the course of a year.

Our recommendation to carve out nonprofit second-class advertising from preferred status may, at first blush, appear to coincide with the above suggestions. But that decision was premised on an a priori judgment of the "unrelatedness" of those activities. (We explain in Appendix B the other factors we considered alongside the relatedness standard in making this judgment.)

In sum, we find our relatedness standard preferable to other options because it is a recognition that some judgment is involved, but attempts to minimize the degree of judgment, as well as minimizing the infringement on charitable purposes and postal operations.

---

[2] See Complaint of Tri-Parish Journal, Inc. d/b/a River Parishes Sun, PRC Op. C85-2 at para. 120, November 20, 1985 for a discussion of some of the difficulties of distinguishing advertising and editorial matter. In that case, the Commission had to analyze standards for second-class eligibility.

iii. Second Class

In this section we recommend a rule that would eliminate any subsidy of advertising matter in preferred publications through revenue forgone appropriations. The history, purposes, and internal logic of second class justify such a recommendation. See Appendix B, at 79-81. Our task is simpler in second class than in other classes because the second-class rate structure constains separate rate elements for advertising content. Since we can charge the same rates for advertising in preferred and regular rate mail, we do not have to apply the relatedness test, case by case, to this subclass. We now turn to a discussion of the particular form such a rule should take, and of the likely consequences of implementing that solution.

Elimination of Separate Subsidized Advertising Rates. Our recommendation, which was discussed by several witnesses at our hearings, is to retain preferred postage rates for editorial content but eliminate preferred postage rates for advertising content. Thus, the advertising portion of nonprofit publications would be charged at the same regular rates currently paid by commercial publications.

This change in advertising rates would offer a number of advantages. First, it would effectively reduce the amount of revenue forgone appropriations by approximately $5 million. Second, it would do so while preserving the distinction between subsidization of editorial content and subsidization of advertising matter. Editorial matter, which is most closely identified with the nonprofit publisher's recognized institutional purpose, would continue to receive appropriations support; only advertising would lose such support. Third, this rate revision would create a more "level playing field" for nonprofit and commercial publishers; their respective costs of entering advertising matter into the postal system would be the same. Finally, as an incidental benefit, eliminating the separate nonprofit advertising charge would mean one fewer rate element in the complex set of rates applicable to second-class mail.

There are some drawbacks to this approach. Obviously, the mailing costs of nonprofit publications would increase to the extent certain publications contain paid advertising. The available evidence indicates, however, that the cost impact is not likely to be great for the majority of nonprofit publications.[3] In our view, any such potential detrimental effects would be outweighed by the desirability of eliminating the current anomalous subsidy of advertising matter.

Another potential drawback has to do with the structure of regular second-class advertising rates. Recent Commission efforts to redesign regular second-class rates to track known patterns of cost behavior more closely have resulted in regular rates that are somewhat more complex in structure than current nonprofit rates. Having heard no complaints from regular rate second-class publishers since the implementation of these rates, we are confident that nonprofit publications will be able to adapt to the somewhat different regular rates.[4]

On balance, then, we recommend the option of "equalizing" advertising rates for nonprofit and commercial second-class publications. We do recommend one refinement, however: retention of the current rule that allows up to 10 percent advertising matter in a publication without charging advertising rates.[5] In our opinion, this rule serves as a "safety net" to immunize negligible amounts of advertising matter -- including "self-advertising" by the nonprofit entity that publishes the

---

[3] Apparently, less than 25 percent of outside-county nonprofit second-class volume has more than 25 percent advertising content. See Appendix E, Table B4.

[4] To implement our recommendation, it would be necessary to conform nonprofit second-class rate design with regular-rate second-class rate design. This would involve incorporating into the piece rate an editorial/advertising distinction corresponding to that in regular second class.

[5] As noted above, nonprofit publications containing less than 10 percent advertising content currently are rated as if there were no advertising content, on the implicit assumption that such limited amounts of advertising are merely incidental.

periodical -- from application of the higher advertising rates. Maintenance of this "safety net" would not, in our opinion, compromise the overall objective of eliminating appropriations support for paid advertising matter.

Restricting Eligiblity to Publications With Little or No Advertising. Another possible approach would be to restrict eligibility for nonprofit rates to publications that contain no advertising, or only a minimal amount of advertising. Under such a rule, any publication containing more than a negligible amount of advertising would become ineligible for any preferred rates, even the rates applied to editorial content.

Several potential advantages might be cited for this approach. First, it would clearly delineate those publications that most evidently merit preferred status by limiting their contents to editorial material, which most directly advances the educational, scientific, or other recognized purpose on which the publisher's nonprofit status depends. Secondly, we anticipate that such a rule would be comparatively easy to administer. No longer would the publisher or the Postal Service have to calculate the relative proportions of editorial and advertising content, so long as the latter did not exceed a nominal amount -- e.g., the current 10 percent figure. Furthermore, the rate structure of nonprofit second-class mail would be simplified by elimination of the advertising poundage charge. Finally, this approach would be directly responsive to the concerns that have been expressed by commercial publishers, who must pay regular rates. Because nonprofit publishers would be restricted to a minimal amount of advertising content in order to preserve their eligibility for the preferred rates, the competition for advertising between such entities and commercial publishers would necessarily end.

On the other hand, such a rule might be viewed as excessively draconian. Excluding all of a publications's contents (even editorial matter) from preferred rate eligibility because of the presence of a small amount of advertising could justifiably be challenged as throwing the baby out with the

bathwater. We are unaware of any basis for concluding that the editorial portion of a nonprofit publication that does accept paid advertising is any less deserving of preferred rate eligibility than is a publication consisting wholly of editorial matter. Indeed, we anticipate that application of such an extreme rule would create an invidious distinction between otherwise similar categories of publications, and would create an unwarranted disincentive against nonprofit entities' exploration of taxable -- but perhaps financially necessary -- sources of revenue from paid advertisements. Consequently, we do not recommend adoption of this potentially effective, but unduly detrimental, approach to eliminating the subsidization of advertising matter.

iv. Third Class

Unlike second class, third class has always been the characteristic advertising-mail class, and no flat advertising ban is appropriate. Our task is to distinguish among advertising uses by framing rules based on relatedness. We note again that 72 percent of nonprofit bulk third class mail contains no advertising, so the eligibility of this mail for preferred rate status is not addressed here.

To organize this effort, we will begin with the categories of items advertised set out in the reconciliation legislation: "article, product, service, insurance, or travel arrangements." It will become clear that we can treat "article" and "product" as equivalent terms. It is interesting that Congress chose to include two specific types of services -- insurance and travel arrangements -- along with the general term. There are two possible reasons for singling out these activities: (i) they are thought to raise particularly troublesome unfair competition questions, and/or (ii) they are thought to be particularly hard to defend as elements in a program presumably aimed at some charitable, scientific, educational, or other subsidizable end.

Products. Because of the extreme breadth of the terms "article" and "product," making up lists of products that could or could not be advertised at the preferred rate would be a hopeless task. Some sort of general rule is required. Based on our UBIT analysis, the first requirement for obtaining preferred status is that the product and its distribution be related to the subsidized purpose of the organization otherwise than through the production of income. See Treas. Reg. Sec. 1.513-1(d). This principle itself disposes of the case where the eligible organization does no more than purchase a product wholesale, resell it in essentially the same form, and apply the profits to its charitable mission. Selling of this kind is not among the subsidized purposes recognized by the postal statutes (or the Internal Revenue Code); hence the advertising or distribution of the product cannot serve such a purpose.

However, where an organization distributes products to its beneficiary population in their capacity as beneficiaries[6] the issue is not as simple. Here the purpose of selling the product is not solely the production of income to finance the organization; it assists the beneficiary group directly. This suggests that preferred rate eligibility might be desirable in this situation. This principle, however, if not substantially qualified, might give rise to exceptions larger than the rule. Suppose a nonprofit organization had as its purpose the benefiting of all Americans over 65 years of age, and that it offered by mail a complete range of nonprescription drugs, medical appliances, and so on. The philanthropic purpose of the entity is incontestable, and we may assume that it is able to limit its discount sales to buyers in the beneficiary age group; still, the potential unfair competition raised by the program is so troubling as to suggest something wrong with the rule.

The flaw is most probably in the diffuseness of the causal relationship between this kind of activity and the achieving of the entity's primary purpose. The advertisement and sale of an article commercially available through other sources may advance that purpose, but is not necessary to it. Moreover, the more closely the sales activity approaches an ordinary commercial transaction the less causal connection it has with the organization's purpose. If the purpose of the organization is simply to place medical supplies or education books in the hands of a population thought to need medication or education assistance, then it is by definition achieved more thoroughly if these products are distributed free or for nominal prices than if they are sold in a commercial, competitive manner.

Since unfair competition is a major consideration in approaching this problem, we must decide whether to (i) make actual competition the determinant or (ii) limit the possible

---

[6] Example: an entity organized to combat a particular disease also distributes to persons suffering from it a medical appliance useful in controlling or medicating it.

unfair competition by restricting the cases in which the cost advantage of preferred postage rates is available.

The first alternative would obviously require far too much case-by-case investigation to be practical for postal purposes. While the scale of inquiry would be smaller, the types of issues raised would resemble those of an antitrust case (price and cost data, market definition, etc.). The second alternative, on the other hand, better lends itself to the development of clear and concise rules, although it is not based purely on economic distinctions.

We recommend the second alternative. A workable rule defining the relationship between the product and the organization's function is that any product advertised in a mailing must be "actually manufactured" (or equivalent terms) by the members or beneficiaries of the organization. Such a rule reasonably assures that the product is directly a part of the activity for which the nonprofit organization is deemed worthy of subsidy, since the identity of the persons actually making the article acts as a proxy for its relation to the subsidized purpose. In contrast, where the exempt organization could carry on activities through a contractor there is no assurance that the subsidized purpose is being served in a way other than the production of income.

Similarly, this rule does not allow preferred rates for mail advertising products not made by the members or beneficiaries but distributed to them because the product is useful in their capacity as beneficiaries. In this case there is no necessary causal connection between the beneficiaries' obtaining the useful product and the organization's selling it, since the product is available on the market as well.

Services. The promotion of services is at least as diverse a category of advertising as the promotion of products. In addition, because of their intangible nature, services cannot be classified so readily on the basis of their point of origin. A

product, at least, is physically manufactured at some point in time and space; but a service may result from the differing, and simultaneous, efforts of several actors.[7] This may affect the way we examine its relatedness to the purpose of the nonprofit and judge the appropriateness of preferred rates for the mail that advertises it.

This suggests that we might have to subdivide the category and draft different rules for the subdivisions (apart from travel and insurance services which, as noted, we will address separately).

Promotion of services also poses a more difficult problem than promotion of products because of the prima facie relatedness of many kinds of service. There are few instances, among the current categories of eligible nonprofit bodies, of a product being related to the organization's purpose. But many organizational categories are defined wholly or partly in terms of the particular service. For example:

-- educational organizations are defined in part by the primary purpose of "instruction or training of individuals for the purpose of improving or developing their capabilities";

-- scientific organizations "disseminate technical information";

-- agricultural organizations may, among other things, hold "agricultural fairs," engage in "rearing, feeding and managing livestock, poultry, bees, etc." or "collect . . . and disseminat[e] information or materials related to agricultural pursuits." DMM sec. 623. The quoted phrases can certainly be considered to describe services, since in each case there is, or could be, a patron or recipient who benefits from the activity.

---

[7] Example: a local nonprofit performing-arts organization sponsors (by arranging for facilities, advertising, selling tickets, etc.) a performance by a touring theatrical troupe (which may or may not be a nonprofit entity). If the service is the presentation of this performance in this community, then it is the joint accomplishment of the two entities. If the service is defined as "bringing good theater to the community of X," then arguably it has been performed mainly or solely by the nonprofit.

Does it follow that all of these activities are "related" to the primary purpose of the nonprofit entity?

Under current law and regulations eligibility to use preferred rates depends entirely on the nature of the organization, not on the activity or information in the mail piece. We cannot continue current practice if we are to distinguish among uses of the mail by concededly eligible organizations.

This would suggest, first, a general rule analogous to that for products: that a service may be advertised at the preferred rate if it is "actually rendered" by the members or beneficiaries of the organization. This rule would require a direct relationship between the organization and the service. It might eliminate jointly produced services, however. In cases where the service resulted from joint effort, we would have to decide among threee options: (i) any degree of involvement by the nonprofit would suffice to make the service eligible; (ii) any degree of involvement by an ineligible person would suffice to make the service ineligible; or (iii) some intermediate rule.

The first option is, at best, roughly equivalent to the often-criticized status quo. It would sanction what are now thought of as abusive cooperative mailings (where the nonprofit is brought into the enterprise for the sake of its mailing permit). From the standpoint of our relatedness theory, a cooperative mailing of this kind has no connection with actually carrying out the organization's function except the production of a certain amount of income -- an insufficient nexus, as we saw above. It is the activities actually carried on by the nonprofit which we expect to promote the primary purpose, and in this case its "activity" is simply facilitating a mailing. This is so even when the service or event advertised is within the nonprofit's normal areas of activity. There now exist regulations barring cooperative mailings involving an entity not eligible for preferred rates. However, Postal Service finds them difficult to administer, and enforcement is sporadic at best.

We considered recommending an intermediate rule under the third option; but we finally concluded that such a rule would be infeasible to administer. Under such an intermediate rule, the nonprofit would be allowed to show that its mission requires the advertisement of services by ineligible persons. In such instances, mailings would be permitted as an exception. While this compromise is intellectually appealing and might in theory be more equitable than an absolute ban on joint ventures, we believe that the administrative burden on the Postal Service would be too great.

On balance we recommend the second option -- holding that any involvement by an ineligible person disqualifies the mailing for preferred rates. For example a nonprofit could not solicit its members to sign up for a certain credit card using a subsidized mailing, since the credit card company is a necessary joint producer of that service. While it is true that such a ban could cause hardship, where, e.g., a local nonprofit performing arts society sponsored a dramatic performance by a visiting for-profit theater company, we believe such examples to be isolated.

There is one category, education, which presents special problems. In our hearings, an area of competition that was highlighted involved the sponsoring of seminars by nonprofit organizations. A large part of the difficulty with educational-organization mailings stems from the broad definition of educational organizations eligible for preferred rates. Arguably, the best way to handle this problem is not through a ban on certain mailings, but a narrowing of the definition of educational organization. We discuss this in detail at pages 51-56 infra.

Travel and Insurance. Congress mentioned these two forms of service separately in the reconciliation legislation. There may well be reason to treat them differently from the class of services generally.

While it is always possible to think of exceptions, insurance is intuitively not an eleemosynary activity. The same can be said of travel "in its pure state" -- i.e., travel not

engaged in for the sake of health, education, or some other purpose to which the travel is a necessary adjunct. When a travel or insurance arrangement is purchased, it benefits the purchaser in the same way as any other consumer good or service. (This view entails the idea that soliciting funds in order that someone else may travel -- e.g., a group of underprivileged children -- is not advertising of travel in the sense Congress had in mind. This conclusion seems reasonable, if we assume that competitive problems were the primary reason for singling out travel as a special case.) Services in general, on the other hand, may well include activity that benefits more than just the purchaser or recipient.

Of the two services, travel presents the more complex problem. It can appear in a range of contexts, from purely recreational travel which is sponsored in an essentially passive way by an eligible organization, through travel having incidental educational or other features supplied by that organization, to essentially educational, religious or medical objectives with only so much travel as is necessary to that purpose. If we take the view that travel per se -- the mere going from one place to another -- is not within any existing subsidizable purpose, then only the last-mentioned kind of promotion would be acceptable at the preferred rate. Insurance, on the other hand, does not normally subserve any additional purpose; it is bought for its own sake. The selling of insurance, again, does not seem to fall within the present list of subsidizable goals.

We recommend that all promotion of insurance and travel be excluded from preferred rates.[8] Of course, an argument could be made to allow travel necessary to permit effective carrying out of eleemosynary purpose (Examples: an archeological seminar conducted by faculty members at the site of a dig; a religious pilgrimage). Again, however, we believe the administrative

---

[8] The logic which excludes insurance advertising also applies to other financial services.

burden on the Postal Service would outweigh any public benefits in continuing to allow such subsidized mailings.

Gift Premiums. Because of the nature of a premium (i.e., it may or may not be a "gift" in the economic sense), separate treatment of this type of promotion is also necessary. Numerous organizations distribute inexpensive premiums in connection with their fundraising activities. For example, the American Lung Association mails Christmas seals and name stickers, and Twin Cities Public TV offers "nature type things, books, companion books, things of that sort, to encourage membership."[9]

For purposes of analysis, gift premiums may be divided into three separate categories. The first category consists of premiums that are sent to the addressee which may be kept whether a contribution is made or not. The second category consists of premiums that are offered in return for a miniumum contribution, which is much higher than the value of the premium. The third category consists of premiums that are offered in return for a contribution which could equal or closely approximate the value of the premium, but need not greatly exceed it.

In the tax area, under the UBIT line of cases, the first and second categories would be exempt from the UBIT, whereas the third category would fall within it. The courts have found that in the first[10] and second[11] categories there was no threat to the taxpaying businesses and hence no element of competition. The third category, however, contains this competitive element and thus, has been construed to be a commerical activity.[12]

By analogy, therefore, in the absence of practical considerations, we would recommend similar treatment in the

---

[9] Use of Third Class by Nonprofits, Appendix C, page 16.

[10] Hope School v. United States, 612 F.2d 298 (7th Cir. 1980) [greeting cards].

[11] Disabled American Veterans v. United States, 650 F.2d 1178 (Ct. Cl. 1981) [various premiums].

[12] Id.

postal area. That is, the first and second categories would be eligible for nonprofit rates, but the third would not. Again, however, the specter of too great an administrative burden for the Postal Service would lead us to recommend that only the first category be eligible for nonprofit rates. The Postal Service is best able to judge whether it can tell, in every doubtful case, whether a particular premium offer is tantamount to a sale or whether commercial considerations are absent. Thus, the choice between approaches may turn on administrative feasibility.

Potential Hardship. In recommending that severe restrictions be placed on advertising in nonprofit bulk third-class mail we tried to respond to the concern which underlies this entire study -- a reduction in the amount of revenue forgone.[13] We have tried to accomplish this task using a theory which made sense -- relatedness to the exempt purpose of the organization -- while balancing our theoretical principles against the administrative burden on the Postal Service. In addition, we are not unmindful of the hardship that our recommendations might cause certain organizations. For example, our quantitative study of third-class nonprofit mail indicates that 14 percent of this category consists of magazines and journals and half of them contain advertising of the type that we recommend be made ineligible. To the extent that these publications have subscribers or requestors and are published with a regular frequency they would still be able to use second-class nonprofit where advertising does not affect eligibility. Third-class church newsletters with an incidental amount (under 10 percent) of advertising could lose their eligibility for bulk nonprofit third-class rates, but may well be mailable as

---

[13] Our study of third-class nonprofit mail indicates that the savings to the Treasury could be in the neighborhood of $80 million if our recommendations are adopted.

nonprofit second class where such minimal advertising would not be counted. Of course, such hardships are inevitable when benefits previously granted are taken away. However, we are confident that the Congress will, as appropriate, weigh the potential gain in revenue against the possible hardships that nonprofit organizations might experience.

v. Fourth Class

Library rate mail, the preferred subclass of fourth-class mail, differs in one important respect from the other preferred mail categories. In addition to a variety of nonprofit organizations -- e.g., public libraries, schools, museums, and herbaria -- certain commercial mailers are eligible to use library rates. Specifically, publishers and distributors may mail books and related reading matter to schools, colleges, universities and public libraries.

As shown in Appendix F, the special study of library rate usage demonstrates that publishers and distributors are significant users of the subclass: they mail about 45 percent of total library rate pieces, and account for about 55 percent of the subsidy. The Commission is concerned that this significant level of use by private, for-profit mailers may include potentially inappropriate commercial uses of library rate mail. In order to distinguish legitimate from illegitimate uses, it is necessary to determine how our recommended "relatedness" standard should apply to the use of this somewhat different subclass.

In our view, the "relatedness" standard would properly exclude from library rate those mailings that do not further the central purpose for which that preferred mail category was created: to facilitate widespread and inexpensive public access to books and other educational materials available in libraries and kindred nonprofit institutions through the mails.[14] When Congress extended eligibility for library rate mailings to book publishers and distributors in 1976,[15] the following, somewhat indirect, "relatedness" assumption was cited:

---

[14] See Appendix A at 80-109.

[15] Commercial producers of films, sound recordings, and library materials other than books were already eligible to mail such materials to libraries and nonprofit organizations at the library rate. See Appendix A at 99-101.

> Libraries and schools currently receive at least half their books by mail. As a result, every dollar paid for book postage further erodes library and school budgets. The situation is worse for small rural libraries and schools which receive an estimated 90 percent of their books by mail. Under this amendment, these libraries would benefit from the lower rate.

H.R. Rep. No. 94-391, 94th Cong. 1st Sess. 12 (1975).

The testimony and other information presented to us during the course of this study indicates that, in general, this rationale for the eligibility of publishers and distributors remains sound -- if we accept the concept of indirect relationship as an adequate ground for extending a subsidy. Substantial amounts of evidence were presented tending to indicate that publishers "pass through" the postage costs of fulfilling orders to libraries and other not-for-profit purchasers.[16] Thus, eliminating the eligibility of publishers and distributors would increase the total costs paid by libraries and other such institutions, with consequent adverse effects on their budgets.[17] Given this pattern of indirect benefit, and possible detriment, to the favored nonprofit organizations, we have carefully considered whether the rationale supporting the 1976 change is still acceptable.

We do not believe that it is. In our earlier discussion of third-class mail, and, more generally, of the theory of relatedness as a basis for eligibility (Appendix B), we have emphasized that the production of income destined for charitable or other subsidizable functions is not sufficient to make a commercial activity "related" and hence eligible for subsidy. Consistency with this view (which is also embodied in the tax

---

[16] Statement on behalf of the American Library Association, April 18, 1986, at 4; Statement of Sara Galligan on behalf of Minnesota State Law Library, April 15, 1986, at 3; Letter of Emily K. Smith to Chairman Janet D. Steiger, April 21, 1986.

[17] Statement on behalf of the American Library Association, April 18, 1986, at 4; Statement of Deborah Miller on behalf of the Illinois Library Association, April 2, 1986, at 4-5.

laws) requires that we recommend setting aside the even more indirect relation which underlies the extension of library rate to publishers. That extension of the subsidy does not even directly produce income for the nonprofit beneficiary; it results in a saving of its funds if, and to the extent that, a commercial organization passes on the reduction in postage. The theory we recommend elsewhere, in short, does not allow for retention of the publishers' eligibility. Furthermore, the current eligibility standards may allow library rate to be used for promotional purposes -- for example, to advertise a newly published book by sending sample copies to college professors.[18]

Accordingly, we recommend the adoption of legislation that would preclude any commercial entity from using library rate mail. The Commission estimates that this recommended change will reduce the appropriation for library rate by $12.2 million.

---

18 Our quantitative study of library rate could not distinguish sample copies. We were able to determine that 6.3 percent of the volume is sent by publishers or distributors to the attention of individuals at colleges or universities. Since many of these pieces may not be sample copies, this figure represents at best an upper bound on the extent of the practice.

B. Redefining Categories of Mailers

This section of the Report discusses some possibilities for redefining categories of nonprofit organizations as a means of reducing the use of subsidized second- and third-class rates. In this regard, the Commission was not directed to present recommendations, but we discuss some options the Congress might want to consider.

From the time that exemptions for nonprofit organizations were enacted by Congress, the Post Office was faced with the task of determining which applicants for nonprofit mailing permits were eligible to obtain them and which were not. To a very large degree, postal officials making these determinations relied on Internal Revenue Service treatment of these organizations for purposes of their exemption from income taxation. This view persists today. However, the theory which exempts nonprofit organizations from paying income taxes may not be a good model for determining their continued entitlement to postal subsidies. Some tax scholars believe that nonprofit organizations are not really the beneficiaries of "loopholes" in income tax laws, nor are they specially privileged. Rather, they are truly not the kind of income-producing entity that could be subject to income taxation.[19] Thus, there is no necessary nexus -- either in logic or in policy considerations -- between exemption from taxation and entitlement to lower operating costs in the form of reduced postal rates.

Changing the Definition of Nonprofit "Educational" Organization. Our study of nonprofit organizations uncovered the fact that the definition of "educational" nonprofits is so broad that many groups now may use preferred rate categories in ways that might not have been intended by Congress. For example, opinion-making entities, widely-distributed publications containing a large volume of advertising, and seminars offered for high fees all have been able to qualify for subsidized rates

---

19 Bittker and Rahdert, "The Exemption of Nonprofit Organizations from Federal Income Taxation," 85 Yale L.J. 299, 304 (1976).

under the present definition of "educational" embodied in Postal Service rules.

Before considering how these rules might be recast, we should note that they may be subject to serious practical difficulties.

Sections 300.02121(b) of the Domestic Mail Classification Schedule and 623.232 of the Domestic Mail Manual express the current definition of "educational" matter. The DMM section reads, in relevant part:

> .232 Educational. A nonprofit organization whose primary purpose is the instruction or training of individuals for the purpose of improving or developing their capabilities or the instruction of the public on subjects beneficial to the community.
>
> Note: a. An organization may be educational even though it advocates a particular position or viewpoint as long as it presents a sufficiently full and fair exposition of the pertinent facts to permit an individual or the public to form an independent opinion or conclusion. Conversely, an organization is not considered educational if its principal function is the mere presentation of unsupported opinion.

This is substantially the same as the Internal Revenue Service rule defining "educational" for purposes of 26 U.S.C. sec. 501(c)(3). See 26 CFR 1.501(c)(3)-1(d)(3).

This regulation has been held unconstitutional for vagueness. In Big Mama Rag, Inc. v. United States, 494 F. Supp. 473 (D.D.C. 1979), Judge Sirica considered both the "instruction . . . on subjects beneficial to the community" and "full and fair exposition" branches of the rule. He found that the first of these "[i]n the context of the government's argument . . . would be far too subjective in its application to pass constitutional muster." 494 F. Supp. at 479 n. 6. However, he upheld the IRS on the "full and fair exposition" point, ruling that the

publication in question had "adopted a stance so doctrinaire that it cannot satisfy this standard." Ibid.[20]

The Court of Appeals agreed with the first holding, but reversed the second. Big Mama Rag, Inc. v. United States, 631 F.2d 1030 (D.C. Cir. 1980). As to the "subjects" test, it said:

> The first portion of the regulation . . . measures an applicant organization by whether it provides "instruction of the public on subjects useful to the individual and beneficial to the community." . . . The district court rejected that test with barely a murmur of disagreement from appellees. . . .
>
> We find similar problems inherent in the "full and fair exposition" test . . . . That test lacks the requisite clarity, both in explaining which applicant organizations are subject to the standard and in articulating its substantive requirements.

631 F.2d at 1035-1036. The subsequent discussion indicates that similar difficulties may threaten neutral enforcement of the corresponding postal regulation.

The IRS succeeded in denying educational exemption in National Alliance v. United States, 710 F.2d 868 (D.C. Cir. 1983). The applicant for educational exemption was described by the court as "repetitively appeal[ing] for action, including violence, to put to disadvantage or to injure persons who are members of named racial, religious, or ethnic groups." 710 F.2d at 873. The IRS advocated a four-part test it has developed to cure the vagueness in its regulations, pointed out in Big Mama Rag. The court reaffirmed that case, but said that the National Alliance's activities were simply outside any possible definition of education:

> We assume that the court in Big Mama viewed the activity of BMR, Inc. as falling within the range of reasonable interpretation of 'educational' as used in the statute, or at least not clearly outside such range. Thus the vague test [of the regulation] posed a real risk that BMR, Inc. might have been denied exemption under the test while

---

[20] This decision is discussed in a Comment at 128 U. Pa. L. Rev. 849 (1980).

> others not distinguishable on any principled objective basis might be granted exemption.
>
> In the present case we see no possibility that the National Alliance publication can be found educational within any reasonable interpretation of the term.

710 F.2d at 875. The court specifically declined to decide whether the government's four-part test would cure the vagueness denounced in Big Mama Rag. 710 F.2d at 876.

We need not try to decide whether the result would be the same if the benefit sought were entitlement to nonprofit rates. There is no reason to think it would not; but the important point is that the current rules deserve reexamination in light of the D.C. Circuit's destructive analysis, to which they are clearly subject.

Reexamination calls for more than sharpening the eligibility test to remove constitutional difficulties. It entails considering whether all the entities that fit within the current definition are entities Congress wishes to subsidize.

As the rules now stand, for instance, two basic categories of "educational" activity are included: instruction of individuals through some type of teacher-student relation;[21] and dissemination to the general public, often through mass mailings of third-class matter, of information and arguments about a subject of public interest. (Frequently the mailer of the latter kind of educational matter has a distinct point of view; promoting it does not disqualify the mail, under the rule, unless it is expressed too one-sidedly.)

It should be emphasized that this possible dichotomy is not the same as distinguishing "traditional" educational institutions

---

[21] It is true that in its initial efforts to interpret the education category, the Post Office Department restricted eligible organizations to those offering instruction through a pupil-teacher relationship. The Senate criticized the practice, causing the Post Office to construe the language much more liberally. Appendix A at 76. (The concern then was in part over alumni associations, which at least reflect the existence of such a relationship.)

with regular faculties, enrolled student bodies, and prescribed curricula leading to a degree, diploma, or certificate. While that too is a distinguishable kind of educational institution, it does not exhaust the class of entities capable of giving instruction through a student-teacher relationship. An adult continuing education association, for example, may offer courses singly or in any combination the interested patron chooses, and may offer no academic credit of any kind. Few would say that if educational mailings are to be subsidized at all, these organizations should be excluded.

Another possible point of distinction is the existence of some "agreement to be educated" on the part of the recipient of the information or instruction. Clearly this would include any education arrangement of the student-teacher type; it might also allow second-class matter, as currently defined, to be subsidized while excluding mail sent to recipients who have not asked for it and are not aware, until they receive it, that an organization wishes to instruct them on its subject matter.

This is so because eligibility for second class (regular-rate as well as nonprofit) requires some indicia that the mail is valuable to the recipient. For this reason, a certain threshold proportion of actual paid subscribers (or requesters, if the publication is distributed free) is a prerequisite to second-class entry. This rule was recently reexamined and reaffirmed. Complaint of Tri-Parish Journal, Inc., PRC Docket No. C85-2 (November 20, 1985). One key reason for the paid-subscriber rule was that it restricted the advantageous second-class rates to publications for which there was a concrete indication (in the form of subscription and payment therefor) of public demand.

It could thus be argued that, since a periodical seeking entry to the nonprofit category as "educational" must have such subscribers or requesters to qualify for second class at all, we can presume that at least a majority of recipients actually desire the information and teaching it contains. Congress may be willing to count this as an educational relationship even though there is no teacher-student interaction. If so, educational

eligibility could be defined to require an actual teacher-student relation only in order to receive a third-class permit.

We describe these options not in order to press one or another of them on Congress as a recommendation, but to indicate two things:

-- "education" under current rules is an enormously diverse category of nonprofit eligibility, containing much mail that in everyday language would seldom be termed "educational" or the output of an "educational" institution; and

-- it is possible to develop at least a few structural distinctions which could serve as the basis of contracting eligibility, if Congress wishes to do so, while avoiding the perils of restricting the subsidy on the basis of content.

Existing data do not reveal the relative extent of usage by "traditional" educational entities, periodical publishers,[22] and "opinion-making" organizations. This is to be expected, since the present rule makes no internal distinctions in the "education" category; but it also leaves us unable to state the dollar impact of possible restrictions.

Mutual Benefit vs. Public Service Organizations. The history of nonprofit rates has been described in detail in Appendix A. That history indicates that the preferred rates for nonprofit mailers were created in an almost offhand fashion, but were occasionally studied in a more analytical way. One interesting distinction that emerged in the course of such a study was that between nonprofits that furnish some service to all members of some community or class of persons, and those organizations that exist solely for the mutual benefit of their own members. A charitable hospital or a school could fall in the

---

[22] Several prominent magazines, such as Ms. and Harper's, are issued by nonprofit foundations and mailed under educational permits.

first category ("public service") while a fraternal order or labor union might fall in the second ("mutual benefit").

This distinction, though, has not been applied in practice. Nonprofit rates, from the creation of the second-class preferred rate in 1917 through the institution of third-class nonprofit rates in 1951, did not apply it. During the next 30 years, Congress added more groups to both special rates. Typically, the proposal to add one or another preferred mailer was part of a major bill to raise rates; the debate about rates overshadowed everything else. Rarely was there any discussion when Congress broadened the coverage of nonprofit rates.[23] In particular, it has not been clear why Congress included some types of nonprofits but not others. Service clubs, for example, were intentionally excluded when the special third-class rate was created in 1951.

What has been clear, or at least consistent, is the public policy of extending mailing privileges to certain types of qualifying entities: religious, philanthropic, and educational (public service organizations). These types -- which might be grouped under the legal rubric "charitable" -- exist largely to serve individuals other than their own members. Besides, they often perform tasks that would otherwise revert to government.

On the other hand, the primary and immediate beneficiaries of other groups -- agricultural, veterans, fraternal, or labor (mutual benefit organizations) -- are their members. Thus, some have argued, there was less justification for their low rates. The leading advocate of this approach was Charles A. Heiss, commissioned to conduct a study of second-class mail some 40 years ago.[24] Similarly, a 1967 House bill tried to bring the list of eligible organizations more in line with this policy. It would have permitted the third-class mailings of religious,

---

[23] See Appendix A at 6-7.

[24] See Charles A. Heiss, Report on Second Class Mail (Government Printing Office, 1946), especially pages 25-28.

philanthropic, and educational organizations to pass at the special rates. Other groups, however, would have been entitled to the lowest rate only when their mailings were made in connection with some public charitable service. In short, public policy justified a subsidy only for mailings that provided direct benefits for other than the sender and receiver.[25]

The dichotomy between mutual benefit organizations and public service organizations has a certain appeal from a public policy perspective. It should be pointed out, however, that the mutual benefit entities which currently use preferred rate categories appear to represent a very small part of the total usage of preferred rates and therefore their exclusion would be likely to contribute little to any financial savings. Our study indicates that, at least with regard to third class, educational organizations, which fall in the public service category, are the most significant user of nonprofit rates.[26]

---

[25] Appendix A, pages 5-6.

[26] This chart was generated by the Dunn and David Study commissioned by the Postal Rate Commission, for a study of third-class mail users.

PERCENT OF TOTAL BY TYPE OF ORGANIZATION

	TYPE OF ORGANIZATION								
	RELIG.	EDUC.	SCIEN.	PHILAN.	AGRI.	LABOR	VET.	FRAT.	POLI.
VOL.	26.2	32.6	6.9	24.7	0.7	0.7	5.1	2.9	0.3

THE WITHIN-COUNTY SECOND-CLASS RATE SUBSIDY

The within-county rate. The second-class within-county mailing rate applies to copies of otherwise qualifying second-class publications delivered to addresses within the county of publication if the copies are mailed at the post office of original entry (or at an office of additional entry) within the county of publication. Postal regulations take into account independent incorporated cities and mailings to destinations within the county, but served by a post office outside the county. In general, in-county rates are lower than the corresponding second-class nonprofit rates. The within-county subsidy for fiscal year 1985 amounted to $78.5 million, or a little more than half of the $147.1 million in revenue for within-county mail. 1.84 billion pieces were mailed at the within-county rate in FY 1985.

Origin of the within-county subsidy. The within-county subsidy originated in 1851 as a means of providing free postage for publishers of rural weekly newspapers who faced competition from urban papers. It was a somewhat more generous variation on an 1845 provision which, for the two years it was in effect, had given local newspapers the competitive advantage of a 30-mile postage-free circulation zone. Until then, rural weeklies had been on the losing side of the prevailing postal policy that fostered inexpensive long-distance distribution of newspapers through the mails. Dr. Richard B. Kielbowicz, an authority on the history of newspapers in the mails, provides this description of the competition underlying the early congressional efforts to reshape postal policy:

> Taking advantage of low newspaper postage, city publishers actively courted subscribers in the country. Often they retained local agents to solicit and forward subscriptions. By 1820, papers in a dozen or more of the largest cities were publishing special editions expressly for circulation in the countryside. . . . The most notable weekly edition of a major daily, Horace Greeley's New York Tribune, attracted a huge

national following, perhaps a million readers.[1] (Footnotes omitted.)

Although the mileage-based mailing privilege enacted in 1845 was short-lived, congressional sentiment in favor of protection for rural publishers had taken firm hold and, after several unsuccessful legislative attempts to restore it, the subsidy reappeared in 1851 in the form of free county-wide postage for weekly newspapers. Congress settled upon the county as the appropriate boundary for free mailing privileges after rejecting proposals for zones that would have encompassed the congressional district in which a newspaper was located, the state in which it was published, or up to thirty, forty or fifty miles from the newspaper office. It appears that the county may have won out over the other choices because its economic and political importance at the time overshadowed its chief drawback, which was a lack of uniformity in size and population.

The delivery service that accompanied the original free in-county privilege differed substantially from that of today because the Post Office had not yet initiated carrier delivery to homes and businesses. The in-county privilege entitled papers to free transportation from the post office of entry to other offices in the same county; they were not delivered directly to readers. In fact, when carrier service was established in 1863, there was a fee for newspaper delivery; it was only publications sent to subscribers on Rural Free Delivery (RFD) routes that were entitled to free home delivery in the county of publication. Nonetheless, the free RFD privilege continued to protect local publications from larger metropolitan papers. In addition, the newspapers paying for in-county delivery enjoyed a rate advantage that, once built into the system, was maintained and enhanced.[2]

---

1 Appendix A at 22.

2 Id. at 33-34.

Indeed, according to Dr. Kielbowicz, the within-county preference for newspapers -- with either free or reduced rates -- has survived since 1851 with only one brief interruption, making it one of the nation's oldest continuous federal subsidies for a particular type of business. Kielbowicz notes that even when regular second-class rates faced greater scrutiny, few recommended eliminating or sharply curtailing the in-county privilege. He attributes this attitude to the perception that not much revenue was lost and to "the solicitude shown by policymakers for country papers in particular and rural postal services in particular."[3] That solicitude is still apparent today, evidencing itself most recently in this statement by the Committee on Governmental Affairs of the United States Senate: "The intent of this preferred rate was to enable rural publications, not national publications, to serve the area."[4]

Despite the original intent behind its creation, the within-county subsidy lost its exclusive association with rural weeklies in 1874 when eligibility was extended to newspapers with other publication frequencies. It was expanded to all qualifying second-class matter in 1879.[5] At that point, the subsidy took on the broad applicability it has retained to date, with users ranging from small-town publishers or county weeklies to urban and suburban daily newspapers, nonprofit publications (including the religious press), and major national weekly magazines. Survey results bear out the extent of present-day eligibility: of 35,563 second-class mailers represented, 15,455 -- or 43% -- use within-county rates. Of these 15,455 publishers, 4,853 are nonprofit publishers and 10,602 are commercial (general) mailers.

---

3 Id. at 35.

4 Report at 390.

5 For a detailed discussion of the history of the within-county subsidy, see Appendix A at 20-46.

It appears that expanded eligibility may have occurred less as a conscious decision to allow more publications into the category than as the result of inadvertence and compromise as the modern classification system took shape. A recent indication of Congressional concern over the direction the subsidy has taken is a provision in the 1985 Consolidated Omnibus Reconciliation Act which denies eligibility for the in-county rate if the number of copies of an issue distributed within the county of publication is less than half of the issue's total paid circulation. This limitation does not apply if the issue's total paid circulation is less than 10,000 copies per issue. A more restrictive provision -- which would have limited availability of the in-county rate to 20,000 copies per issue -- was not included in the final reconciliation legislation.

This limitation restricts two practices that were made possible by the broadly-worded legislation relating to use of the in-county rate. One practice was for a publisher to designate a publication's "known office of publication" in a county where a large number of copies were mailed. A May 1985 General Accounting Office report, which identified six national publishers who had designated Los Angeles County as their known office of publication, said that the original offices of publication of four of the six publications had been in New York. The GAO said that by designating Los Angeles as their known offices of publication, the publishers substantially increased their use of the within-county subsidy. The other practice involved mailings of special weekly issues by daily newspapers using a "total market coverage" concept.

This recent change is not the first expression of Congressional concern over the use of in-county rates: in 1967, Congress recognized that a 1962 provision designed to accommodate rural publishers' use of centralized printing plants outside the county of publication could also be used by large magazines to qualify for the in-county rate and passed an amendment which limited within-county rates to the office of original entry.

The House report recommending this amendment said:

> In-county rates are being turned to different ends than Congress envisioned more than a century ago when in-county rates were first established. . . . While these rates were intended to help the rural press, volume growth is taking place largely around metropolitan areas.[6]

Survey results. Total in-county volume mailed by all publications is 1.9 billion.[7] Of this amount, nonprofit mail accounts for 642 million pieces and general (commercial or for-profit) accounts for 1.26 billion pieces. Although the lion's share of the subsidy goes to commercial mailers because they put almost twice as many pieces into the in-county mailstream as nonprofits, the latter nonetheless benefit to a considerable degree.

Frequency. As indicated previously, the subsidy was originally intended for weekly newspapers, but was later extended to publications of any frequency. Today, the survey shows that the weekly category accounts for 32.5 percent of the total volume mailed by nonprofit in-county users and 23.3 percent of the total mailed by general publications using in-county. The monthly category accounts for 28.8 percent of the total annual nonprofit volume, but only 12.3 percent of general publications' volume.

The figures for daily publications are perhaps the most interesting: they show that while 17.1 percent of the total volume of nonprofit in-county user publications is in the daily category, over half -- 51.3 percent -- of the total volume of general in-county user publications is attributable to dailies. Furthermore, when general in-county publications are compared to general outside-the-county publications, it appears that there

---

[6] H.R. Rep. No. 722, 90th Cong., 1st Sess. (1967) at 31, cited in Appendix A at 46.

[7] This is an estimate for FY 1986, reflecting an approximate growth rate of 3 percent over FY 1985 volume.

are almost twice as many within-county publications, in percentage terms, as outside-the-county.

Annual copies mailed. It is clear from the survey that the majority of the 1.9 billion pieces in the annual in-county mailstream are entered by mailers in what generally could be considered the large and very large categories of in-county users. In the nonprofit group, 63.2 percent of the total annual volume is entered by mailers with over one million annual mailed copies (34.6 percent in the one million to ten million category and 28.6 percent in the over ten million category). In the general publications group, 68.9 percent of the in-county user volume is the large and very large category: 53.3 percent is in the one million to ten million category and 15.6 percent is in the over ten million category. Accordingly, the 1.9 billion annual in-county volume is not a phenomenon created by an extremely large number of very small publications; indeed, total annual volume entered by in-county publishers with less than 10,000 total copies in the mail is less than half of one percent for both nonprofit and general publications. Even when the small category -- 10,000 to 100,000 copies -- is considered, there is not much additional annual volume; another 10.4 percent of nonoprofit in-county user volume falls into this category and a little more than half this amount -- 5.5 percent -- is in the general publications category.

Type of publication. Of the nonprofit in-county user volume represented, newspapers represent 31 percent and magazines represent 69 percent. In the general category, an opposite relationship occurs: 61.5 percent are newspapers and 37.4 percent are magazines. This seems to indicate that general newspapers, which were the original beneficiary of in-county rates, constitute the largest proportion of current general in-county user mail volume. However, when general and nonprofit publications are merged, newspapers hold only a slight lead over magazines, with 51.7 percent versus 47.5 percent.

Copies per mailing. When annual in-county user volume is broken down to a copies per-mailing basis, about 20 percent of

the total annual nonprofit volume is contributed by in-county mailers entering under 10,000 copies at a time. However, 30.5 percent of the total annual general publication volume is generated by mailings entering under 10,000 copies per mailing.

As mailings per-issue move toward the medium category, with 10,001 to 100,000 copies per mailing, nonprofit in-county mailers account for 36.7 percent of the annual nonprofit volume and general mailers account for 55.4 percent of the annual general volume. There is a dramatic difference between nonprofit and general mailers in the large and very large categories: in the 100,001 - 1,000,000 category, the nonprofit percentage of total nonprofit in-county user volume is 43.0 percent versus 8.3 percent for general publications. In the very large category -- over a million copies per mailing -- the percentage of total nonprofit in-county user volume is near zero versus 5.8 percent of the volume entered by general publications.

Impact of restricting eligibility for the in-county rate. A recent provision enacted as part of the 1985 Omnibus Consolidated Budget Reconciliation Act restricts eligibility for the within-county rate by denying it to periodicals with less than half of their total paid circulation distributed in the county of publication. Survey results show that this restriction eliminates 2,020 publications and 225 million copies of previously eligible within-county volume. 13,435 publications survive the in-county eligibility change and their 1.67 billion copies remain eligible for the subsidized rate. This change produces about $9 million in savings.

The Senate version of the reconciliaton bill would have further restricted the subsidy by limiting eligibility to the first 20,000 copies of each issue of a publication that survives the in-county distribution test. Survey results show that with this added limitation, another 352 million copies would no longer be eligible for the within-county rate. This would produce an additional savings of an estimated $14 million. The combined effect of the two restrictions in terms of volume is the elimination of 578 million copies or about 30 percent of

previously eligible copies. In terms of savings, the effect is an estimated $23 million.

Testimony from our field hearings translates some of our anonymous survey data into "real life" situations. For example, Mary Polanco, speaking on behalf of many religious press associations, summed up their assessment of the new restriction this way:

> We believe that religious periodicals were never the intended target of the restrictive rules of in-county rates. The abuses of in-county as cited in Congress has to do with the profit-making periodicals and "skin" magazines. Unfortunately when the rules on restricted use of in-county rates were written, no exclusion was granted for the nonprofit press, so many of our periodicals received a rate increase in mid-February.[8]

According to Presnall H. Wood, editor of 350,000-circulation The Baptist Standard, the official weekly publication of the Baptist General Convention of Texas, the new in-county restriction has resulted in a weekly postage increase of $600.[9] However, Elaine Smith, testifying on behalf of the Texas Catholic, a weekly with a circulation of 41,800, said that the new restriction has not affected its rates because over half of the paper's circulation goes to subscribers within the county of publication.[10] However, it appears that the Texas Catholic would lose eligibility for many of its copies if the additional 20,000-copy restriction were enacted.

In an April 18, 1986 letter to PRC Chairman Steiger, Dr. John Stapert submitted a tabulation of the circulation of the Associated Church Press's member publications. This

---

8 Tr. 3/74-75.

9 Tr. 5/187.

10 Id. at 111.

tabulation showed that of 138 periodicals, 53 publish 10,000 or fewer copies per issue. Accordingly, these publications, regardless of their in-county/outside-the-county distribution, are not affected by the new distribution restriction because of the special provision for small publications. Since the tabulation did not break down the in-county/outside-the-county distribution of the periodicals, there is no way to determine how the other 85 publications are affected by the new restriction. However, if we assume the most favorable circumstance -- that the ACP periodicals meet the distribution test -- a look at the same tabulation discussed above in terms of 20,000-copy cap, shows that 67 of 138 ACP periodicals have circulations over 20,000 and presumably would be capped.

Comment. The Commission was not asked to make specific recommendations on restricting or eliminating the within-county subsidy, but we think we would be remiss if we did not point out what appears to us to be a problematic aspect of the within-county subsidy. By this, we refer to the various terms -- sometimes used interchangeably but inherently different in meaning -- that were used in reference to this subsidy. Some persons called it a subsidy for "small publications," others called it a "rural" subsidy, and still others referred to it as a "local" subsidy. However, as our data show, more large publications appear to use it than small publications and the vast majority of in-county volume is distributed in areas of more than one million persons. In addition, nonprofit users, who are already eligible for preferred second-class rate, also benefit from the in-county rate. In light of the broad eligibility for within-county rates, revealed by our survey in the field hearings, it appears that further discussion of eligibility must focus more precisely on which mailers are intended to be the beneficiaries of the within-county subsidy. If it is only small-circulation rural publications who are to benefit, then the present eligibility criteria -- drafted in terms of the geopolitical unit of the county -- is overly broad and clearly allows other types of mailers into

the category. However, it may be that instead of simply small rural publications, it is periodicals that provide predominantly "local coverage" -- whether their circulation is in an urban or rural area -- that should benefit from the subsidy.

In sum, the within-county eligibility standards appear to warrant a closer look to determine whether they are, in fact, consonant with Congressional intentions regarding the intended beneficiaries.

Attachment I

Suggested Statutory Language to Direct Postal Rate Commission to Establish Rates and Classifications to Recognize the Benefits Provided by Mail Currently Subsidized Pursuant to 39 U.S.C. § 3626

SEC. 1. The first sentence of section 2401(c) of title 39, United States Code, is amended by deleting the comma and adding the word "and" between the phrases "sections 3217" and "3403-3405," and by deleting the phrase "and 3626."

SEC. 2. Section 3622(b) of title 39, United States Code, is amended by --

(a) redesignating paragraph (9) thereof as paragraph (10);

(b) deleting the word "and" at the end of paragraph (8) thereof; and

(c) inserting a new paragraph (9), as follows: "(9) the public benefits provided by classes of mail and kinds of mailers formerly eligible for reduced rates under section 3626(a)(1) of this title, as in effect immediately preceding its repeal, and the effect of rate changes on ability to provide such benefits; and."

SEC. 3. Section 3626 of title 39, United States Code, is amended by --

(a) deleting subsections (a) and (c) through (e) thereof;

(b) redesignating subsection (b) as subsection (a); and

(c) adding a new subsection (b), as follows:

"(b) For purposes of the administration of section 3622(b)(9) of this title, the definition of classes of mail and kinds of mailers formerly eligible for reduced rates under section 3626(a)(1) of this title shall continue to be governed by the former provisions of subsections (c) through (e) of this section."